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# **A Framework and Analysis of Small Firms in Russia: Illustrated by the Food-Processing Industry in Rostov Oblast**

A thesis submitted to Middlesex University  
In part fulfilment of the requirements for the degree of  
Doctor of Philosophy

**Karen D Taylor**

School of Health and Social Sciences  
Middlesex University

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# Abstract

This study analyses the complexity of small firm (SME) formation in the 1990s, as Russia underwent systemic change. SME formation helps maintain the dynamism of a market economy and it was capturing this quality that was important for Russia. The role of SMEs in Russia however, was undermined by low formation rates, especially in manufacturing. To examine what was determining this, both the food-processing sector, where it was common to find start-ups in other transition economies, and Rostov oblast, a well-known agricultural region able to support such a sector, were chosen.

An initial review of literature showed that no economic activity, should be divorced from the economic, political or socio-cultural environments within which it is embedded. These three environments consequently formed the basis of the conceptual framework that guided this meso level inquiry. In addition the framework incorporated analytical concepts drawn from institutional economics, the entrepreneurship literature and regional economic development to facilitate a comprehensive and fully contextualised explanation.

This study argues that throughout Russian history formal and informal institutions have shaped the opportunity structure for SME formation. In the 1990s new and old institutions maintained the dominance of former state-owned enterprises. For SMEs these same institutions had not reduced transaction costs sufficiently to encourage the exploitation of emerging opportunities, and they even appeared to be pushing SMEs into the informal economy. Moreover although a nascent middle class was emerging it remained risk averse, so that it was not an obvious source for SME entrepreneurship. The whole situation was further complicated by low trust levels, which limited economic relations to the local and the personal.



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# Glossary and List of Abbreviations

FDI	Foreign Direct Investment
FIG	Financial Industrial Group
IE	Institutional Economics
OIE	Old Institutional Economics
NEP	New Economic Policy (1921-8)
NGO	Non Governmental Organisation
NIE	New Institutional Economics
R & D	Research and Development
RED	Regional Economic Development
SMEs	Small Medium Enterprises
USSR	Union of Soviet Socialist Republics
Barshchina	labour without payment (payment to the landlord with labour obligations)
Blat	system of mutual favours largely not involving money
Donskaya Oblast	the Don region, which in 1937 became Rostov oblast
Duma	legislature in post-Soviet period
Fermerskie Farmers	individual private farmers
Guberniya	administrative unit introduced by Peter the Great and abolished in the Soviet period
Informal Economy	also known as the second, shadow, unofficial, black, hidden, underground, pirate, counter, parallel
Kolkhoz	collective farm – peasant co-operative
Kolkhoz Market	a farmers market, where kolkhoz peasants took their household plot produce to sell
Kulak	rich peasant
Kustar Industry	cottage industry or handicraft enterprise
Nomenklatura	a system of state and party posts and the people who might fill these posts
North Caucasus Economic Region	region containing krais, oblasts and republics in the south of Russia. Renamed the Southern Federal District in May 2000
Oblast	region or province
Obrok	payment in kind or money
Obshchina	peasant village commune also known as mir
Raion(i)	locality at lower level than oblast
Remeslo	artisan industry in urban location
Serfs	peasants who could be bought and sold, owned by state, landlord, church
Southern Federal District	The new name for the North Caucasus Economic Region
Sovkhoz	state farm
Tolkach(i)	pusher/expediter(s)
Tribut	money given to obtain a favour
Votchinal	factory on noble estate
Vziatka	bribery, obtaining favours through money
Zemstvo	form of local self government



# Chapter 1

## Small Business and Transformation in Post-Soviet Russia

### Chapter Outline

This introductory chapter establishes why there is a need to examine small firm formation in a transitional environment such as Russia's. It begins by explaining the contribution that small business makes to the economic wellbeing of a nation state. In post-Soviet Russia, small firm formation during the 1990s was relatively slow. Experiences from many other parts of the world indicate that there are many factors and contexts that need to be examined to explain this. What becomes apparent from the experiences of different countries is that small firm formation differs as the context within which it develops differs. The context usually examined is the economy, but no two economies are exactly alike, for economies are shaped by politics, which define and enforce economic rules (institutions) and by society within which they are culturally embedded. Not only has the context in Russia been different to western capitalist countries, but this context has evolved over time, along a different path trajectory. An understanding of the past as well as the current political, economic and social contexts has the potential to aid a deeper understanding of the way that small firm formation was taking place there during the 1990s. In order to analyse small firm formation the main task of this study was to create a conceptual framework in which to characterise and present the relevant contexts, and order the key explanatory concepts that were established as important in the literature review. In addition the research questions and aims that direct this study are phrased to reflect the need to understand context and historical evolution.

### 1.1 Introduction

Small business has not always been in vogue, in fact for most of the twentieth century its existence was considered to be evidence of low levels of economic development (Storey, 1983). The belief that large firms were vital for improving economic development dominated in both the countries of the developed West and of the Eastern bloc. This view was supported by classic writings in both economics and sociology, which for over one hundred years had shown that large firms were evidence of development (Curran, 1991). 'Bigness' was understood to be more efficient due to all the advantages associated with economies of scale<sup>1</sup>. As a result there was widespread belief that small business, being less efficient, would inevitably disappear (Bannock, 1981). This faith in large business was however undermined by the severe world-wide economic recessions that occurred in the 1970s.



The economic turbulence of the 1970s seemed to have a profound and largely negative effect upon large firms. Contrary to received wisdom it appeared that it was large firms that were contributing to economic stagnation (Acs and Audretsch, 1983). Small firms on the other hand appeared to be more resilient and adaptable to the changing market conditions. Furthermore evidence suggested that in some countries small firms were even outperforming large firms (Acs and Audretsch, 1983)<sup>2</sup>. The consequence was a growing 'love affair' with small business both in the economic discourse of the West and in numerous western governments' economic policies. In the former USSR, however it appeared that faith in large business remained unshakeable. That was until the late 1980s, when limited permission was granted for some small independent businesses known as co-operatives to operate predominantly in sectors providing consumer goods and services. This 'love affair' with small business appeared to be spreading even to a die-hard socialist country such as the Soviet Union (USSR). Even so, in the former USSR it remained a muted 'affair' compared to the West. In 1991 though the unthinkable happened; the USSR collapsed, ostensibly due to its economic inefficiencies. Since then western economic theoreticians and policy makers have been advising the countries of the former Soviet Union, including the Russian Federation, on developing a market economy. After all, despite its imperfections, the 'market has won' (Lavign, 1995).

One of the promulgations of pro-market change is the need to develop small and medium sized businesses (SMEs). The development of SMEs in a former administrative-command economy such as the former Socialist Republic of Russia would be understood as evidence of a determined move towards creating a market economy; for SMEs are themselves an important element in the foundations of any market economy (Gibb and Lyapunov, 1996). To understand the importance of small firms it is essential to understand their role in a market economy.



## 1.2 The Role of Small Business in an Economy

The reason why small business is now considered important is due to the potential roles that it can play in economic development. Since the late 1970s research on small business has highlighted the contribution that it can play in an economy (as summarised in table 1.1).

Table 1.1 The Potential Roles of Small Business in an Economy
<ul style="list-style-type: none"><li>• Smallness facilitates greater flexibility, more responsive to change in the economic environment.</li><li>• Contribute to the development of new markets and industries.</li><li>• Increase the level of competition at the regional, national and international levels.</li><li>• Tend not to be inflationary being price takers rather than price makers.</li><li>• Labour intensive; contribute to reducing unemployment during periods of restructuring.</li><li>• A source of innovation.</li><li>• Contribute to a regions income generation via external sales or import substitution.</li><li>• Contribute to economic well-being of an economy by being a supplier or customer of large firms.</li><li>• Grow into larger companies.</li><li>• Help to diversify the size structure of firms in an economy.</li><li>• Contribute to sectoral restructuring, from manufacturing to the tertiary sector.</li><li>• More committed to local communities; source and recruit locally therefore less geographically footloose.</li><li>• Development of a middle class creating stakeholders with an interest in a market economy.</li><li>• Support the development of democracy.</li></ul>

(SOURCE Bannock, 1981; Acs and Audretsch, 1993; Smallbone et al, 1994a, 1996c; 1999a,b,c,d)

Many if not all of the potential roles for small business are now cited as important for Russia, as it copes with the legacies of its socialist past in transforming its economy from being state to market controlled (see Smallbone et al, 1994). A planned economy relies on the state taking over many of the roles shown in table 1.1 that small business would inhabit in capitalist countries. The nature of socialist planning meant that many of these roles would simply have made planning as practised in the Soviet Union (for example allowing the management of enterprises to decide what was produced and which materials were used) unfeasible. Other roles such as increasing competition were simply ideologically at variance with the basic



principles of Marxism-Leninism on which the Soviet Socialist system was founded. Planning left limited scope for an SME sector to exist in a Soviet economy. Furthermore, the Soviet state was unable to take over enough of these roles to harness any of the potential dynamism that would have been created by SMEs in a market economy. Consequently it is possible to argue that not having a small business sector must have contributed somewhat to the increasingly poor performance of the Soviet economy from the 1970s on.

The following is a brief description of some of the basic characteristics of a planned economy. As with most countries, which operated under socialist principles, the economic plan (rather than the market) provided the USSR with economic features that simply did not exist in capitalist countries. The state owned all the means of production; through the plan it set industrial production and prices making competition irrelevant. Planning all economic activity was a complicated process, eased by the creation of large vertically integrated state-owned enterprises. Moreover, the plan rather than consumer signals guided the economy and this was reflected in the importance socialist ideology assigned to heavy industry and the production of military and producer goods over the consumer industry. The state economic plan though was far from perfect, and there were potential dire consequences for enterprise managers failing to ensure their enterprises met the plan's requirements (Harter, 1997). Consequently there was a tendency of state enterprises to hoard all inputs including labour. The incentive to establish and develop a business rested with planners and state officials rather than with other individuals. This resulted in an economic system and enterprises, which over the years had become increasingly inefficient, inflexible and unresponsive to change. Developing a market type economy on such a system in which the development of industry has been distorted to this extent would be a herculean task. One way to establish a market economy fairly quickly as well as ease many of the imperfections



in a former planned economy is to make the development of small business an integral part of the transition process.

### 1.3 Small Business and Post-Soviet Russia

The lack of independent small business was a typical feature of the old Soviet economy (Aslund, 1997b). As noted above transformation of Russia's economic system includes the need to develop its own indigenous independent small business sector. The literature on small business within post-Soviet Russia sometimes fails to acknowledge that not every small business is independently owned. Although it is well known that enterprises in the former Soviet Union were extremely large, it was possible to have some sectors in the consumer industry that were organised on a much smaller scale<sup>3</sup>. Unlike in the West, size tended not to be determined by the numbers of employees but rather by quantity produced. This project however, is not centrally interested in understanding how these 'small-scale' former state enterprises (or how spin-off small businesses formed as a result of the downsizing of large firms) are coping with the transformation process. This study is principally concerned with *indigenous small businesses*, which did not previously exist in the former economic system.

There is however, one sector of quasi-independent small business, which did exist, in the former economic system. These were the small firms that operated in the informal economy<sup>4</sup>. It was well known that firms of all sizes (and not just restricted to the retail sector) existed in the informal economy. Details about them naturally are sketchy, but there is work documenting their existence and the reasons for their survival (Cohen et al, 1998; Davies, 1987; Grossman, 1997, 1998; Hedlund, 1989). Although these enterprises were not state-owned, the nature of their independence especially during the Soviet period is debatable. In a planned



economy where the state controlled all resources, they relied for their existence on the state sector for inputs, premises and equipment. Furthermore, their output was taken into consideration when plans were drawn up. These enterprises were tolerated, despite being antithetical to the whole principle of a planned economy, simply because they helped to iron out the imperfections in the plan. This not only helped out state-owned enterprises in the fulfilment of their plans but also contributed to helping the state fulfil the needs of its population. The fact that some, one might say quasi, 'private' activity did exist meant that there was potential capability and potentially a favourable attitude (by those involved in the informal sector) to the formation of capitalist small businesses when the old system collapsed. It was therefore expected that changing the economic system to one with much fewer restrictions would not only bring out enterprises from the shadow economy, but also encourage the formation of entirely new small businesses.

Removing the restrictive elements of the planning system was expected to release hidden energies which could then lead to the formation of new businesses and a small business sector (Bryant, 1994). It would then not be unreasonable to expect a relatively fast growth in the number of small business in post-Soviet Russia. The numbers of small businesses has, however been below expectations, and those that have established have predominated in the tertiary sector (Aslund, 1997b). Some analysts have indicated that the initial spurt of small business development in the first two years declined as a result of a 'natural stabilisation in the dynamics of small business'. Others feel that this interpretation may just be a 'smokescreen' (Avilova et al, 1996), especially as in the first two years the economic environment was particularly turbulent and the banking system was in the process of change, making bank credit almost non existent. Furthermore the decline in the formation of small business curiously coincided with the time when support directed to small business was being developed at national and regional levels. In addition and again



contrary to expectations, enterprises in the informal economy have not transferred to the formal economy, and it appears that the informal economy is continuing to grow (Chavance et al, 1997).

Research conducted over many years in different capitalist countries and recently in the Russian Federation and Eastern Europe has highlighted problems that may have had a negative impact on small firm formation (Storey, 1994; Birley, 1996; Paradis et al, 1998; Gustafson, 1999; Aslund, 1997b; Smallbone et al, 1995a,b, 1996a,b,c, 1997, 1999a,b). This research has indicated that finance, taxation, inability to profit from R and D (research and development) and insufficient business advice and support, are factors that may slow down small firm formation or restrict the growth of existing small firms. Although this literature highlights important issues, that undoubtedly have some influence on small firm formation levels, it is the institutional economics literature on western economies that shows these factors are primarily symptoms that provide only a partial answer. If this is the case for western economies, then examining the context for these factors becomes imperative for a thorough understanding of small firm formation in an economy like that of Russia, where the recent economic system was so different.

Context for example becomes important when examining the role of finance, for it appears that small firms do not always use costly sources of external finance, to aid their survival. Instead they may use one or several 'bootstrapping' measures such as buying used equipment, renting equipment or borrowing money from relatives and friends (Winborg and Landstrom, 1997). The use of 'bootstrapping' measures has been found to exist almost everywhere, but is particularly common where bank finance is limited or unavailable for example in transition economies. One recent study found that in Poland it was usual to find small firms borrowing from friends and family or using their own savings (Freiberg, 1999). This highlights how



important it is to apply a local contextually informed interpretation of the enabling and constraining roles of factors such as finance for an in-depth understanding of them in different cultures. Another example of the importance for contextual interpretation comes from understanding why it was that business support agencies in the past in Scotland had not been more encouraging to indigenous small firm start-ups. Although research had shown a strong aspiration within the adult population to start-up businesses, it appears that support agencies provided more encouragement to inward direct investment. So although officially these agencies (and government departments) were to encourage small firm formation, this work was hindered by the perception that the overriding business culture in Scotland was anti-enterprise and one of dependency on large firms for employment (Danson, 1995).

Understanding what affects small firm formation rates and the types of small businesses that develop is more than simply listing a set of factors or concepts. The context within which these factors present themselves becomes just as important. This entails organising, prioritising and interpreting these factors or concepts in accordance with information on local conditions. This study aims to understand the role of various factors or concepts that the small business research literature has highlighted, by placing them within a framework that emphasises how specific historical and geographical contexts shape their operation and outcomes. As 'context' here is considered of primary importance it follows that an aggregated study covering all industry and services throughout the whole of Russia held the potential for being less useful than a project that concentrated on one industrial or manufacturing sector in one specific region.

Like all countries throughout the world, Russia is made up of many different regions each having its own unique industrial and cultural history as well as climate and natural resources. Generalising at the national level about these and other



variables, (for example those commonly discussed in the small business literature such as availability of factors of production) runs the risk of underplaying their importance. One way to overcome this potential problem is to concentrate on one sector within one region of Russia with the natural resources capable of sustaining it. The choice of sector was determined mostly by research already conducted within a variety of countries in the former Eastern bloc which were at various stages within the transition process. This research showed that one of the manufacturing sectors experiencing new small firm formation relatively early on in the transition process was food-processing (Smallbone, 1996c, 1999a; Smith, 1996).

In Russia, the areas with a comparative advantage in agriculture and hence with the capability of supplying the raw material needed for food-processing are located in the South in the North Caucasus economic region (re-named The Southern Federal District from May 2000<sup>5</sup>). Rostov oblast or region in the North Caucasus was chosen for a variety of reasons. Firstly the region has the advantage of a wide industrial base. This means that the composition of Rostov oblast's industrial sectors is sufficiently varied that it should have some sectors that will have been less severely affected by transition than others and this may concomitantly have helped to keep unemployment levels lower than in other regions. High rates of unemployment can be damaging because they have the potential to reduce overall levels of consumption, which in turn could affect small firm formation in consumer sectors such as food-processing. In addition Rostov oblast is one region in the North Caucasus with a high ratio of urban to rural inhabitants indicating a potentially large consumer market for processed food products. The final factor taken into consideration was that Rostov oblast was in the top ten of Russia's regions in the 1990s for having the largest number of small business formations (Passport, 1998).

This study was designed to analyse small firm formation in one sector of industry (food-processing) in one region of Russia (Rostov oblast/region) during the 1990s, or in other words the early years of the transition process. It is a study that not only looks at the factors or concepts established in the small business literature but places these concepts in context. Economic activity such as small firm formation is to some extent shaped by the societal context within which it exists, because it is undertaken by individuals born into societies with developed cultures or belief systems as well as polities, which have all exerted some influence on them. The state's influence on economic activity is for instance felt through its policies and regulations formed at both the local and national level. Moreover societal context is continually evolving over time due in some part to advances in knowledge and technological change. Certainly the social, political economic and technological contexts in Russia have changed dramatically from Tsarism to Socialism to Capitalism. As with the change to Socialism, the early transition period (namely the 1990s) in Russia was not taking place on a clean slate. On the contrary the new market type economy was being installed on top of the former Soviet system that had been in existence for over 70 years. The result is that many of the ingrained habits and routines from the old Soviet system are likely to be transferred into the new market economy, influencing the way economic activity develops in Russia. The *evolution* of context makes it imperative to look further back in history to examine the contextual influences on economic activity that were incorporated into the Soviet system from before the revolution. This required going back to the beginning of manufacturing on a scale larger than self-sufficiency, which in Russia is to the time of Peter the Great. These issues were subsequently incorporated into the research aims and questions that guided this study.



## 1.4 Research Aims and Questions

Research is needed to explain the fundamental reasons for the slow rate of small firm formation within the manufacturing sector in the post-Soviet Russian economy.

This study aspires to do this and has the following aims:

<p><b>Table 1.2 The Aims of the Study</b></p> <ul style="list-style-type: none"><li>• To create a conceptual framework derived from the literature on entrepreneurship, institutional economics and regional economic development that is capable of interpreting the formation of independent small business within a specific regional context.</li><li>• To apply the framework to understand the circumstances/conditions for independent small business formation. The literature indicates the need to select a region and a manufacturing sector for focussed research.</li><li>• To develop an historical approach as required by the conceptual framework. To achieve this aim a causal interpretation of small business formation from the near and distant historical past of the region within the Russian Federation is necessary. This will incorporate an examination of the socio-cultural, economic and political contexts and their influences.</li></ul>
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The research questions that will drive the study are detailed in table 1.3:

<p><b>Table 1.3 The Central Research Question and Sub Research Questions</b></p> <p>What are the factors and circumstances shaping independent small business formation within manufacturing (a specific sector) over time and spatially (a specified region) in the Russian Federation?</p> <p><b>Sub Research Questions</b></p> <ul style="list-style-type: none"><li>• How does the economic environment, as shaped by the prevailing political and economic institutions, create opportunities for independent small manufacturing business formations?</li><li>• What cultural and social influences have affected the ability of people to engage in small business formation, and how have these factors influenced the kinds of small businesses that have come into existence?</li><li>• To what extent is an historical appreciation of small business formation important as an aid to analysing the situation during the 1990s?</li><li>• What role have the regional authorities and their policies played in influencing the incentive system leading to small business formation?</li></ul>
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The research aims and questions provide an indication of the type of research methodology that this study was to use. The conceptual framework emphasised obtaining data on a wide range of variables on small firms in a specific sector and region in its historical and contemporary contexts. The only way to do this was to have a flexible approach to data collection in terms of research methods and it is the case study approach that provides this. Flexibility in the field was also important for a number of reasons. Firstly conducting research in Russia is not straightforward at the best of times. Research there takes time. It involves cultivating contacts, and if time in the field is limited as a result of cost, flexibility in choice of research methods becomes important. A case study approach for this work proved to be advantageous because it avoided having to rely on just one research method. In particular, it meant that secondary literature could be used not just to explain the various factors and contexts for small firm formation historically but also in the contemporary setting of the 1990s. The secondary literature and statistics used came from a variety of sources (the internet, academic books, newspapers, journal articles) in both Russian and English many of which were specific to Rostov region itself. In addition the literature obtained about small firm formation in the 1990s was supplemented by key informant interviews, which helped to enrich the data obtained.

### 1.5 Terms of Reference

It is essential before going any further to understand what is meant by a *small firm* for this study. It is well known that what is considered a small firm can differ between countries, as it can between support agencies. The famous Bolton report of 1971 provided both a quantitative (statistical) definition based on numbers of employees, and sales turnover and a qualitative definition. As Storey notes this conceptualisation is difficult to use. He provides the example of a petrochemical industry which may have higher levels of capitalisation, sales and employment



compared to a firm in the car repair trade (Storey, 1994). The qualitative definition by Bolton was an attempt to overcome some of the weaknesses of the quantitative definition. As a result it is the qualitative definition that for some researchers is more important (Smallbone, 1997). This study though examines small firms from a sectoral or meso level rather than at the micro level. It therefore has to rely on official statistical sources that are usually based on the numbers of employees, which can pose its own problems.

Numerous research articles and literature analysing the development of Russia's independent small business sector have commented that statistical evidence is not only scant but also unreliable (Aslund, 1997b). Aslund further writes that it was not until 1996 that Russia began to gather and publish aggregate statistics that embraced all enterprises. Another problem with Russian statistics that relate to small business is that the definition of small business has changed at least three times over five years (in 1991, 1993 and 1995<sup>6</sup>) (Aslund, 1997; OECD, 1998). As a result there is a lack of consistency in Russian statistical data. Another problem is that the statistics on small firm formations include former state-owned enterprises, co-operatives, and firms that are registered only but do not operate. As a result the statistics can only provide evidence of a trend in small firm formation within the Russian Federation. Moreover, there are no official statistics on the numbers of small firms forming within the shadow economy, only estimates based on their contribution to GDP (see Gustafson, 1999). Problems with statistics are not new; on the contrary they have existed throughout Russia's history. In Tsarist Russia for example there is evidence that statistics on firms below a certain size were not even collected (see chapter four, section 4.2 on The Small Firm in the Tsarist Period). Statistics consequently are only able to provide an indication of the trend in small firm formation both historically and during the 1990s in this work.



This study accepts the Russian statistical definition of a small firm and combines this into the working concept of a new small firm as being independent from any large firms. This means that a large firm has no ownership in the small firm, and does not have any kind of exclusive relationship precluding any other relationships with other firms for example in the supply of raw or processed material. Unfortunately Russian statistical data does not often provide information about the nature of a small firm's independence, so there can be no guarantee that this intention has been achieved in this research. Despite the imperfections of Russian statistical information the operational definition when using Russian sources is small food-processing firms with less than 100 employees, indigenous and not foreign owned, and new in that establishment was during the 1990s. It must also be stated that although an operational definition has been created for the purpose of this study, many of the academic articles (English and Russian) on SMEs that have been used do not themselves define exactly what is meant by small, complicating the analytical process for this study.

Defining what is meant by small was not the only issue. Another has been to delineate between the terms of transition and transformation in order to use them correctly. Both of these terms suggest that Russia is moving in the direction of creating a market type economy, and yet neither are able to say exactly what kind of market economy is being formed (Killick et al, 1992). Although these terms have been used synonymously it is recognised that there are subtle differences in these two words. Transition has been noted as emphasising the destination in other words moving from one situation to something entirely different (Bryant and Mokrzycki, 1994). For Pikvance it is a process, which lasts for a determinate period of time with an end state known in advance (Pikvance, 1997). This gives the impression that the process is by and large straightforward (Smith and Pickles, 1998). It is however, still unknown what type of market economy Russia will eventually create. It may follow



one of several models that already exist, or it could be a new hybrid type of market economy. As a result the term 'transition' is not used by some, for example the EBRD (Child and Czedledy, 1996). The term transformation emphasises a process of change that is termed evolutionary but with an end state unknown in advance (Child and Czedledy, 1996). 'Transformation' therefore may be considered by many to be a more analytically precise term. Despite the differences in meaning, in much of the literature on Russia in the 1990s the terms *transition* and *transformation* have been used as synonyms. This study will also use these terms interchangeably for stylistic reasons with no assumption made as to the end state of Russia's market type economy, nor is there an assumption on the duration or nature of these changes.

## 1.6 The Organisation of the Study

This thesis has been organised into seven chapters. The following is a brief description of the contents of these chapters.

**Chapter two** identifies the factors from the literature that provides the basis for the conceptual framework to examine small business formation in Russia. The *entrepreneurship* literature was chosen as the point of departure because of its close association with small business development. There are however, limitations to this literature and so it was combined with the *institutional economics* literature to provide a perspective that could compensate for some of them. The institutional economics literature was found to be better in explaining the reasons behind the absence/presence and nature of the economic activity that occurs within national states. As such it has considerable potential for analysing small firm formation within the Russian Federation during the 1990s, with the result that for this study it holds a prominent position in the conceptual framework. As this study is an examination of

small firm formation at a regional level the institutional economics literature needed to be supplemented with another literature that concentrated on understanding economic activity at a regional level. For this reason literature on *regional economic development* was explored. This literature emphasises that within nation states economic activity such as new firm activity varies between regions. In particular the regional economic development literature examines why some regions have become more successful in improving their economic prosperity through small firm formation. This literature has found that small firm formation is driven by important local factors and moreover that this form of economic activity is facilitated by proximity enabling these small firms to achieve economies of scale normally associated with large firms.

Together these three sources of literature not only compensate for the deficiencies in one another, but also formed the foundation stones of the conceptual framework that was developed for this study. The three sources of literature that form the conceptual framework provide a fuller analysis of small firm formation in a specific manufacturing sector and region of Russia over three historical periods.

**Chapter three** continues the development of the conceptual framework, the basis of which was laid down in chapter two, and explains its operationalisation via the adopted research methodology. It orders together the various key concepts from each of the literatures into three groups under the terms political, economic and social environments to create the framework (summarised in diagrammatic form). This chapter also specifies how the conceptual framework can be used to help understand what is happening with small firm formation during the 1990s as Russia changes its economic system. In addition there is an examination of how the analytical framework and practical issues (such as time restrictions in the field) determined the methods used to obtain the data that was then required by the framework.



**Chapters four and five** apply the framework to look at small firm formation from an historical perspective. This historical approach is driven by the contextual emphasis of the conceptual framework, which requires an understanding of how economic activity and the way an economy operates results from the past evolution of institutions. The influence of the past (in the literature ‘legacy’) on the present (in the literature ‘path dependency’) is a major theme that is developed in this study. These chapters predominantly analyse secondary literature from both Russian and English sources to understand the factors and contexts that affected small firm formation in the food-processing industry from the mid Tsarist period in chapter four through the Soviet period in chapter five.

**Chapter six** analyses the situation facing small firm formation in Russia during the 1990s, the period of transformation. It looks for links between the institutions of the past to those that existed in the 1990s. It uses interviews, literature (academic books, academic articles, newspapers) and official statistics to understand the extent and nature of small firm formation in the food-processing industry. Both continuities and discontinuities with the past period are identified. This chapter aspires to contribute to a deeper understanding of the issues that are shaping small firm formation within manufacturing in Russia during the transformation period. Furthermore it demonstrates the ability of the framework to offer a holistic yet penetrating analysis.

**Chapter seven** summarises the findings from the previous chapters. It then highlights the major factors and findings that were found to have direct relevance on small firm formation. It argues that one reason for the problems facing small business formation was the incompleteness, ineffectiveness and inappropriateness of institutions formed during the early transition years of the 1990s. In addition it emphasises the existence of discordance between these new institutions and those

inherited institutions that have remained influential. Consequently this chapter argues the need to acknowledge the continuing influence of the past to ensure that policies and actions undertaken will ultimately encourage the kinds of small firm formations that are needed for successful economic development.

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## End Notes

<sup>1</sup> “Economies of scale used to rule the industrial world. Big was cost effective” (Burns, 1991).

<sup>2</sup> The mini mills in the steel industry are one example. These small firms expanded employment, whilst large firms shut down plants and reduced employment in a number of countries (Acs and Audretsch, 1993).

<sup>3</sup> Although some enterprises would have been organised on a much smaller scale than others, due to the principal of vertical integration, they were still likely to have been larger than would be considered small in the western sense of the term.

<sup>4</sup> Also known as the shadow, unofficial, informal, second, underground, parallel, counter and black economy. Although this study recognises that there is work to show the definitional nuances between these terms, it will use them interchangeably to mean a hidden underground economy outside the official or formal economy.

<sup>5</sup> Although the region has now been re-named the Southern Federal District, The North Caucasus is a well-known and widely used term, which is also present on maps of Russia and the region. Consequently the term North Caucasus will be used in this study.

<sup>6</sup> In 1991 SMEs had up to 200 employees in industry and construction, 100 in science, 50 in other productive activities and 15 in trade and public catering. In 1995 the ceiling for the number of employees in SMEs changed from 200 to 100.



## Chapter 2

# Entrepreneurship, Institutions and Regional Economic Development: Their Importance for Understanding Independent Small Business Formation

### Chapter Outline

This chapter examines different literatures for their usefulness in understanding small firm formation. Firstly the literature on entrepreneurship is examined from different academic perspectives. The aim of this is to identify and evaluate those concepts that are the most useful for investigating small firm formation at a sectoral or meso level. These concepts are then combined to provide a fuller understanding of entrepreneurial activity. There are though limitations within the entrepreneurship literature, especially with regards to understanding small firm formation at the sectoral level. One literature that has the potential to overcome many of these limitations is the institutional economics literature. This literature is particularly concerned with providing a more complete understanding of all economic activity. It starts from the premise that all economic activity is embedded in the socio-cultural and political contexts of a particular nation state. For this study the institutional economics literature proves to be a rich source of concepts, which emphasises not only the need for well functioning institutions, but also the continuing influence of 'inherited' factors on the present and future. Institutional economics though was not specifically designed to understand the small firm phenomenon, and moreover, tends to view economic activity from a national state perspective. Literature in economic geography has highlighted the fact that regions within nation states develop differently as a result of historical, social, cultural, political and economic processes. Furthermore research since the 1980s has shown that regions are capable of creating favourable conditions to enable small firms to successfully operate and make increasingly positive contributions to the regional economy. This has been achieved through regional institutions that co-exist in harmony within national institutions. Consequently places that are proactive in exploiting the strengths of their region are more likely to have a successful small business sector than regions which do not. The final section brings together and summarises elements from the three bodies of literature, which are particularly important for the creation of the conceptual framework (see chapter three) to analyse small firm formation for this study.

## 2.1 Introduction

The purpose of this chapter is to review the literature relevant to small business formation so that a conceptual framework can be created to analyse this activity in Russia. Although there is a wealth of literature, which since the 1970s has recognised the potential positive contribution that small business can make to economic development, there is still a need for greater understanding of what causes or prevents their initial establishment, and the subsequent dynamics of their operation. One approach is through the work on *entrepreneurship*, which has been closely associated with small firm formation. Entrepreneurship is analysed in several academic disciplines. Despite this, the literature on entrepreneurship by itself is not capable of examining the fundamental issues that lead to small firm formation. It is principally concerned with the individual – the entrepreneur and the role



that s(he) plays in economic development neglecting somewhat the wider context of new firm formation. Nonetheless it provides useful concepts and highlights issues, which play a part in shaping small firm formation. The *institutional economics* literature is reviewed next because it has the means to understand the contextual conditions, which over time provide incentives for any form of economic activity (including small firm formation) within a nation state. It is a holistic approach analysing the effects of society and the polity on the performance of an economy. Moreover it stresses the importance of understanding that an economy is not separate from society and the polity; on the contrary it is embedded within them. Furthermore economy, polity and society are not static creations but evolve gradually over time, with continuity being a feature of most socio-economic systems, even when apparently radical transformations have occurred. This means that to understand economic activity in the present it is necessary to understand the past.

The institutional economics literature is supplemented with literature based on institutions within *regional economic development*. There were various reasons for including some of the literature from the regional economic development approach. Firstly it reinforces the institutional economic arguments, but adds to it the notion of uneven spatial development and the processes that cause this. By extending the institutional economics perspective it emphasises that sub-regions within nation states also develop along different trajectories depending on their location, physical assets and local historical development of industry. Moreover, this literature explains the way some regions, with clusters of small businesses, have become successful. It finds that regions themselves can harness not just an appreciation of their own histories but also create and work with groups internal to it, to create a suitable learning environment within which small business can form and develop. Moreover, this school of research has shown that regions that take this proactive position are more likely to have successful development of small firms than regions that do not.

The following sections in this chapter will provide a comprehensive review of important concepts from the literature of entrepreneurship, institutional economics and regional economic development. In other words this chapter will identify concepts and discuss their potential



contribution for analysing small business development from a sectoral and regional viewpoint. The chosen concepts will then be used in the conceptual framework that will be developed in chapter three.

## 2.2 Starting Point: Entrepreneurship and Small Business Development

Entrepreneurship has been widely associated with small firm formation (Cook and Nixon, 1995). Although it is a well used term there has been little consensus in defining exactly what it is. This issue is further confused by researchers acknowledgement that not every small business is entrepreneurial<sup>1</sup>. Kilby has written about this showing that what is entrepreneurial for one researcher is not recognised as such by another (Kilby, 1971)<sup>2</sup>. Kilby suggests that one potential reason for this is that when examining the entrepreneur there has been insufficient care in analysing the economic environment within which the entrepreneur operates. Not only will this study address this issue by taking a contextual approach, but it will need to discount a substantial body of the work on entrepreneurship, which has only examined the individual and his/her role.

Some research that will need to be discounted is the work conducted in the *psychological model of entrepreneurship*, which concentrates on finding characteristics or traits that entrepreneurs have in common. There are many criticisms of this approach (Morrison, 1998; Stevenson and Sahlman, 1991; Goss, 1991; Shaver and Scott, 1991) not least because many of the traits can be found among individuals who are not entrepreneurs but are successful athletes or leading politicians (Morrison, 1998). Consequently it appears that the psychological model disregards the person-situation context and interactions between them (Shaver and Scott, 1991). As the individual is not examined in this study it follows that only the body of work on entrepreneurship, which provides some insight into the context will be examined. The models that are able to contribute to this are:- the *economic model*, the *sociological model* and studies on the *supply and demand for entrepreneurship*.



## 2.2.1 The Economic Models of Entrepreneurship

The earliest model of entrepreneurship is found in the economics discipline and dates from around 1755 when Cantillon (2001) attempted to define a role that he found interesting within the business sphere. The *economic model* defines the various roles for an entrepreneur within an economic environment. The most common roles identified in the literature are risk-taking, opportunity seeking, combining factors of production and being an innovator. These are particularly useful when trying to understand the behaviour of an individual and the types of firms that are subsequently formed. Two roles namely innovation and combining factors of production, are particularly suited to an in-depth micro level investigations. For an analysis conducted at the sectoral or meso level these terms are unable to be used with sufficient rigor, at best they could only be used in a limited way. This is because there is no opportunity to examine the exact nature of how factors of production are combined and in what way the business could be considered innovative. Risk taking and opportunity seeking though have been used in studies analysing economic systems, which means there is potential to successfully use these terms in the approach taken by this study.

*Risk taking* is an important concept in economic literature. It is usually associated with investment and a profitable rate of return. In the literature there is however no consensus of opinion about the importance of risk taking as an aspect of role for the entrepreneur. For example Schumpeter considered that risk taking only confused the issue of ownership (undertaken by the capitalist) and innovation (undertaken by the entrepreneur), which for him were separate roles (Lydall, 1992; Binks and Vale, 1990). Others such as Knight did not make such a distinction and consequently considered risk taking as an important role for entrepreneurs (Binks and Vale, 1990). Despite these differences one issue the entrepreneurship literature highlights, when discussing risk taking, is the need to distinguish it from uncertainty. Risk taking is understood as something that can be calculated and insured against, whilst uncertainty is defined as an unidentifiable occurrence that is not possible to predict, for example an economic recession.



The main problem with this literature, which was initially applied to conventional capitalist economies, is that risk taking is often divorced from the environment itself (Altaf, 1988). It is research undertaken in examining small business in economies which have not followed similar development paths to many capitalist countries, that risk taking has been identified as sometimes being more than simply whether a venture is able to make a profit on investment. In the Third World, and for that matter now in transitional countries, all economic activities including small firm formation often have to be undertaken in economic environments subject to severe instability. Moreover this instability tends to be more substantial and encompassing than dealing with temporary up- and downturns in the economic cycle such as those frequently experienced in the West, even when there are similarities. Furthermore, it often has political origins; Russia for example is undergoing transition and this is firstly a political decision that has economic consequences. Transition changes the political and economic environments and in adapting to the new situation the nature of risk facing all business alters. Consequently in explaining small firm formation in Russia there needs to be an examination of the nature of the risk experienced by business, attitudes to risk and risk minimisation strategies.

One overriding difference between western developed nations and the Third World is the starting point from which economic change has taken place, for example the gap in technology which has to be bridged and the extent of privatisation and so on. Another important difference is the extent of private to public ownership. It is well known that in planned economies private firms either were not allowed to exist or were restricted to a small segment of the economy (for example in handicraft firms, in agriculture in Poland or the kolkhoz plot in Russia) (Kornai, 1992). Individuals took a risk if they engaged in any activity, which was outside regulations (moreover what was or was not acceptable changed from time to time and differed between countries in the Eastern bloc) and they faced the distinct possibility of having to deal with the state's enforcement measures. The strictness with which the enforcement measures were carried out fluctuated, depending on changes in official policy towards that activity (Kornai, 1992).



Risk resulting from other structural difficulties in the economic environments of some Third World countries has shaped the strategies that entrepreneurs use to ensure business and family survival. Thus in Peru it was common to find entrepreneurs operating more than one small business (Long, 1979). Another common characteristic of the diversification of activities is that it covers both the production and distribution function (Long, 1979). Additional factors that increase risk to small firms and which have an influence on their ability to survive are irrespective of location for example the level of taxation and the availability of affordable finance. Again one can argue that it is the extreme consequences arising from these factors in the Third World which has the potential to be more significant, especially if one takes into account not just a lower level of economic development but also less stable economic environments. The risk an individual takes on in setting up a small business and the consequences of failure have a potentially far greater effect in the Third World (and in transitional economies) than in the West. Other problems which increase risk for small firms in Third World countries such as Africa are:- low levels of income among the population, the substantial monetary and fiscal subsidies and tax concessions handed out to large enterprises, shortages of factor inputs, poor quality of materials (Neck, 1983) as well as corruption amongst officials. Consequently it is important to identify and evaluate the nature and potential effects of these factors in an economic environment in terms of the risk they pose to the formation and operation of small business.

The other key concept taken from the economic model of entrepreneurship is the nature of *opportunity seeking*. It was Kirzner who connected entrepreneurship with identifying opportunities (Binks and Vale, 1990), though this fails to explain how opportunities arise. Opportunities arise as a result of disequilibrium, however in the literature the debate is ongoing as to whether disequilibrium in the economic environment causes entrepreneurial activity (Binks and Vale, 1990) or whether entrepreneurial activity itself causes disequilibrium (Kent, 1982) and consequently whether entrepreneurship is reactive or proactive. Again, as with risk taking, there is little attempt in the western literature to show how the economic environment shapes the opportunity structure and why (or why not) individuals engage in opportunity seeking that potentially could have resulted in a new



firm. The example of Asia shows how the opportunity structure can be shaped by the wider context. For example during the colonial system that existed before 1965 opportunities were limited to those the colonial powers were not engaged in, namely some crops and spices, the import and export trade and meeting the needs of the domestic market (Tan, 1998). Shaping the opportunity structure in such a manner is likely to have a significant effect on the activities and sectors small firms engage in and may also influence the numbers of small firms that exist or are formed. For example regulations like restrictive licensing and high taxation may not only limit opportunities available for small business in the formal economy, but could also serve as a means for encouraging its existence in the informal economy. Consequently this study needs to appreciate how opportunities are being shaped in order to understand why small firms are forming in certain sectors, their activities and their numbers. The opportunity structure in Russia changed twice in the last century, in 1917 and at the end of 1991, and it is this change to the opportunity structure that needs to be examined in order to fully appreciate its influence on new firm formation.

Although an examination of the opportunity structure and risk taking will be important for this study, the economics model still undervalues the influence of the social context on the entrepreneur. The sociological model was developed to address this shortcoming by incorporating an examination of cultural and societal influences on entrepreneurial activity. More importantly for this study, the sociological model by examining the wider context beyond the individual has the potential to be a useful source of concepts and insights.

### 2.2.2 The Sociological Model of Entrepreneurship

The *sociological model*, not only combines the psychological and economic models but links them to the *social context* within which the individual entrepreneur exists (Morrison, 1998)<sup>3</sup>. In other words small firm formation is understood to be a socially embedded activity influenced by societal and cultural factors (Block, 1990). So although this model still considers the individual as central it does so by trying to understand the multitude of social influences which lead some individuals to engage



in the entrepreneurial process that results in the formation of a small firm. When it was successfully applied to cultures in the Third World it found that different socio-cultural and economic contexts lead to different types of small business development, which in the West might not even be considered entrepreneurial. Thus the sociological model starts from the premise that entrepreneurship leading to small business formation does not occur in isolation from its context, rather that it will differ as this context differs. This can be spatial such as between national cultures but also between regions within nation states, as well as temporal such as in different historical periods (Morrison, 1998; Curran and Burrows, 1987<sup>4</sup>). Therefore the opportunity structure for small firm formation will differ within a time/space context (Stevenson and Sahlman, 1991; Harris, 1973)<sup>5</sup>.

This model not only appreciates the different social and economic environments in the Third World compared to the West, it also emphasises the many factors that may hinder or encourage small firm formations, which even when similar to those affecting western small business can have a more severe effect. Thus one can infer that the characteristics of small firm formation are likely to be different again in the Russian Federation during the 1990s, specifically because its economic and social environments have developed differently to the West and the Third World. Despite these differences, the Russian Federation as with any East European nation shares some similarities with both the West and the Third World. Russia for example has a well-educated population, many areas of industry were highly developed and employed high technology, for example the military industrial complex. At the other extreme communications, transport and some industry were poorly developed especially those in the light and consumer industries. Consequently it is likely that small business in post-Soviet Russia would display a combination of western, Third World and unique characteristics.

The sociological model starts from the premise that the individual is 'embedded' in (or in other words influenced by) the real world within which (s)he lives (Morrison, 1998)<sup>6</sup>. Consequently it fundamentally differs from the economic model where the individual is modeled as an isolated actor seemingly exogenous to its social and economic context, though responding to economic signals



(Scott et al, 1997). The economic model (according to the sociological critique) tends to view the individual as being under-socialised, for influences on an individuals actions are limited to the potential for profit, empowerment, and increasing status. The sociological model, on the other hand, could be criticised for being over-socialised, in other words placing too much emphasis on the influence of the social environment. To overcome this problem the sociological model emphasises, that external factors both influence and are influenced by the individual. In other words structure and agency are mutually influential. The factors that are taken into consideration by the sociological model influencing small business formation are for example: - geography, resources and social traditions (Morrison, 1998; Landes, 1949).

To understand the interaction of the individual with the context and the kinds of opportunities exploited, this model has restricted its analysis both spatially and temporally<sup>7</sup>. Long for instance has through in-depth case studies looked at an individual, who from an early age engaged in entrepreneurial activity by setting up a series of small firms over his lifetime in a specific region of Peru (Long, 1979). In such qualitative investigations of small firm formation and entrepreneurship this model has tended to concentrate on the individual affecting social change (Stewart, 1991; refers to Firth, 1967 and Greenfield and Strickon, 1979) or contributing to economic development (Stewart, 1991 refers to Greenfield and Strickon, 1979; Long, 1979 and Barth, 1972). Consequently it has not so far been used to analyse the factors affecting the extent or nature of small firm formation in a region or over a wide historical time period. Nonetheless this model offers some potentially interesting and useful insights and concepts to analyse small business formation in nations that have developed differently to the West, such as Russia. Some useful concepts and observations are reviewed below.

One particular important insight from the sociological model is that the entrepreneurial process leading to small firm formation occurs in all social and economic environments<sup>8</sup> no matter how hostile. Consequently small firms exist even in unpromising situations. This observation is of fundamental importance because it indicates that no matter how hostile the past economic



environment has been in Russia small private firms will have been evident in one form or another. This model consequently analyses how individuals perceive and cognate opportunities by examining an individual's personal experiences and societal influences (Stewart, 1991; Morrison, 1998; Stevenson and Sahlman, 1991)<sup>9</sup>. In other words (using the concepts originally derived in the economic model) there is an examination of the entrepreneurial response to the opportunity structure. Although this study will be unable to look at an individual's perception of what is or is not an opportunity and how to exploit it, it is still possible to describe the circumstances and conditions that affect small business formation in relation to the wider socio-cultural and economic environments. This can be obtained by looking at the numbers of small firms established as well as finding factors in the environment that may be affecting the opportunity structure and entrepreneurial response such as social groups or societal arrangements, which throughout Russia's history have differed significantly to the West.

Research on small firm formation in less favourable economic environments within the Third World has found that there are some unique features, which might also be evident in Russia. Structural problems and lack of support in the formal economy (Morris et al, 1997) may contribute to evidence of substantial numbers of small firms in the informal as opposed to formal economy which is the case in the Third World compared to the developed West. Despite the evidence that informality tends to restrict the size of enterprises, opportunities in the informal economy for small firm formation exist not just in retail but also in manufacturing. Irrespective of whether small business formation takes place in the informal or formal economies, the opportunity structure is expanding in those Third World countries undergoing industrialisation. Russia, however, is an industrialised country, but it is one that is undertaking a fundamental systemic change from a planned to a market economy. Consequently the opportunities for small business formation should have become more visible since the end of 1991 when the transformation process began. Opportunities though, need to be recognised and culture it seems can influence how they are perceived.



*Culture* is an important element for the sociological model from the point of view of whether or not it incorporates values and practices supportive of small business (Morrison, 1998)<sup>10</sup>. In other words culture can determine how opportunities are perceived and whether they will ultimately be taken up. As a term culture is difficult to define (Ferraro, 1998). It includes intangibles such as knowledge, beliefs, art, morals, values, attitudes, customs, but also laws. Not only is culture a broad term, it also changes over time. The influence of culture is recognised by the economist Casson, who considers that it is so important that it should no longer be viewed as an exogenous factor but should be made more explicit in research on small firms (Casson, 1995).

There is, however, a danger that the causal link between culture and entrepreneurship leading to small business formation may be misinterpreted (Shapero and Sokol, 1982). For example although it might appear that religion or ethnicity may provide a clue to understanding why some people are more inclined to form small businesses this simplistic causal link according to Shapero and Sokol is simply incorrect (Shapero and Sokol, 1982). Shapero and Sokol argue that religion, ethnicity or way of life do not make people more or less entrepreneurial rather they may exclude some people from certain social activities causing them to engage in others not undertaken by insider social groups<sup>11</sup>. As a result it is necessary to look at the social groups that exist at any one time to try to understand which activities are restricted for them and which are not. It is only when this is done, according to Shapero and Sokol, that analysis breaks away from the stereotype image of members of a social group displaying certain actions irrespective of the situations they are actually in.

Culture though is more than social groupings; it also covers moral acceptance of small firms and their formation. In the classical planned economic system, individual success is visible through a career in the bureaucracy or helping to build socialism and guarding against exploitative capitalist activities. Moreover culture in a planned economic system is shaped by an ideology which stresses loyalty to the party, discipline and sacrifice in order to build a superior (economic, political and social) system (Kornai, 1992). This moral imperative stresses that individuals should subordinate



their needs for the good of society, but this is hardly likely to encourage the formation and development of small independent businesses, where one aim is material success for oneself and ones family that socially may be considered selfish or anti-social. As Russia in its recent past was a planned economic system it is necessary to understand to what extent previous cultural norms have shaped acceptance or otherwise of independent small business, and how this has changed during the 1990s.

The sociological model in effect provides a useful understanding of the influence of society and culture on entrepreneurship. Moreover when it is combined with the economic model it effectively embraces an examination of both structure and agency. One body of analytical writing that has developed just such an approach is the supply and demand for entrepreneurship.

### 2.2.3 The Supply and Demand for Entrepreneurship

The economics literature recognises that its own model does not provide sufficient understanding of what is shaping the extent and nature of small firm formation in any economic environment. This is because it disregards important external influences on the opportunity structure. This deficiency is addressed by literature examining the supply and demand for entrepreneurship, though it remains less developed because of continued emphasis on the entrepreneur. Nonetheless the studies on the supply and demand for entrepreneurship are an attempt to integrate into an analysis both the social and economic environments, and moreover place both on the same level of importance (Nafziger, 1988).

In this literature economic factors are understood to affect the demand side (or the need for entrepreneurship), and the social and psychological factors to affect the supply side (or the sources of entrepreneurship) (Harris, 1973). For entrepreneurship to result in small firm formation both economic and non-economic factors need to be reasonably favourable (Wilken, 1979). Russia during the 1990s was going through the early stages of a fundamental systemic change, which



created a great deal of uncertainty but also increased freedom for individuals in both the economy and society. All these changes, which are likely to be both beneficial and disadvantageous, need to be examined to understand the influence they had on the way opportunities were taken up by small business founders.

Unfortunately one deficiency of this literature is the brevity with which the economic factors are discussed providing little in the way of in-depth analysis of the economic context. Presumably this is because these factors are dealt with in more detail elsewhere in the economics literature. Despite this failing the factors identified in this literature need to be taken into consideration. These include:- the availability of *factors of production* (capital or finance, land including premises, labour, and raw materials or vital inputs); *employment conditions* for example wage levels and the *general level of market demand* (Lydall, 1992; Mason, 1991). Mason, an economic geographer, has found that these factors can be highly dependent on location. For example Mason believes that potential entrepreneurs have more *information* in places where corporate decision making functions are located, or where there are seats of governance (Mason, 1991). He also considers that local availability of transport, availability of industrial estates, business parks, taxation policies and social security systems affect levels of entrepreneurial activity. One of the most important factors often mentioned in the literature is the availability of affordable *finance* (Wilken, 1979; Mason, 1991). As some researchers have found, small business more commonly uses personal finance or other 'bootstrapping' measures, especially when the price of finance is high (Winborg and Landstrom, 1997). The advantage of using these factors is that they are tools, which facilitate an examination of the economic context at the meso level and on a regional scale.

The favourability of the economic environment for entrepreneurship and small firm formation is not dependent on one specific factor but on them all (Wilken, 1979). Each of these factors either make it easier or more difficult for entrepreneurs to set up and develop their own small business. This study will use secondary literature and where possible primary data to evaluate the ways these economic factors have restricted and or enabled small firm formation at the regional level.



Moreover an examination of aggregate statistics on small firm formation may, by reflecting a corresponding trend, to some extent confirm the influence of these economic factors. In addition these economic factors do not just influence the extent of small business formation, but will be significant in determining the nature of their economic activities.

Mason(1991) has isolated three environmental factors on the economic side, which the literature on regional small business formation considers to have a significant effect. These are:- the *nature of the industry*, *plant size* and *occupational structure in a region*, which influenced the ability of a region to incubate new entrepreneurs/businesses. All three are controversial, with researchers finding evidence either strongly for or only weakly related in studies covering a variety of different regions. The nature of this study suggests that plant size and occupational structure are of limited use as explanatory variables, and aggregate statistics in the Russian Federation do not show the former occupations of small business owners. Plant size, even when small, was always large in Russia, so it is not a factor with much regional variation. Moreover jobs and production was strongly delineated, and not being a market economy there was limited contact with customers, so there was no need for managers of state enterprises to understand the nature of the market. Thus the kind of training and experience (marketing, cost reduction) that exists in western companies did not exist in Soviet Russia. The final environmental factor is the *nature of the industry* that characterises a region and the ease of setting up a small business within it (either through a new start-up or as a spin off). The activities of small firms often reflect the kinds of industries that already predominate in a region. Regions that are dominated with large industries such as ship-building, steel or coal, however, are unlikely to attract new small-scale imitations because of high entry costs and the improbability of commercial success on anything other than a large-scale. Likewise regions with a varied industrial structure and industries that may be imitated successfully on a small-scale, should find this reflected in the statistics. It then follows that it would be useful to examine the existing industrial structures in Rostov oblast and compare the result with statistics depicting the nature and extent of small business formation for each of the historical periods in this study. These three analytical devices that have been traditionally used in spatial research on small



firm formation have though been criticised for producing a static picture of a regions' economic structure. Consequently they are no longer used exclusively to provide explanations; rather they are combined with a broader understanding of what constitutes the economic structure of a region and the kinds of economic relationships that exist within this structure (Kratke, 1999).

Social influences on the availability (or supply) of entrepreneurs for small business formation have largely been considered irrelevant in standard economic theory, which emphasised only the need for a suitable legal framework. Social factors influencing the supply were not considered to cause problems because it was assumed that a free market and freedom to engage in small business would stimulate an infinitely elastic supply of entrepreneurs (Lydall, 1992)<sup>12</sup>. This economic assertion according to the sociological model fails to appreciate the importance of social influences on economic activity. Social influences differ between nations as they do between regions (whatever their size or substance) which indicates that the sources for entrepreneurship will also differ. As with the economic factors affecting the demand side some literature merely lists many factors, which are equal in influence. Though there is also research that contains more analysis about the various factors liable to influence the ability and willingness of individuals in specific social groups to engage in entrepreneurial endeavours (Wilken, 1979). Some such as the *presence of key social groups* (and the nature of their entrepreneurial activity), the *legitimation of entrepreneurship* in a society, (whether undertaken by marginal or mainstream social groups) and the effect of on *social mobility* (upwards or downwards) can be usefully applied to a meso level enquiry such as this.

There are similarities here with the sociological model, especially on the inclination of social groups to engage in entrepreneurship (see the discussion in section 2.2.2 on The Sociological Model of Entrepreneurship). In addition the supply side acknowledges that entrepreneurship leading to small business formation has to be socially acceptable for it to be carried out on an extensive scale. Even outsiders must to some extent be accepted into society, not just to sell to the insider groups but also to gain access to factor inputs (machinery, materials, land and premises and



so on). In looking at Russia it is necessary to consider the extent to which independent small business is socially accepted. Acceptability will have a major influence on the numbers of small firms formed, for example few small firms were formed in Russia during the 1930s when individual business activity was denounced not just as morally unacceptable but also had serious repercussions for those who dared to be involved. The supply side of the analysis provides an opportunity to examine the way social attitudes to independent small business formations has changed over time, which social groups became involved with it and how this legacy has affected the kinds of small businesses established in the 1990s.

The literature on entrepreneurship is adequate at examining how the economic and socio-cultural contexts influence small firm formation (Peterson, 1988) but it overlooks examining the influence of the actual economic system itself. There are four conditions, which characterise the way any economic system operates:- the extent of property rights including the degree of state and private ownership; whether economic information is distributed by the plan or the market; whether decision making is by individuals within firms or by the administration and whether the incentive for people to make economic decisions is based on the market or morals<sup>13</sup> (Gregory and Stuart, 1999). Essentially these factors analyse whether individuals or the state are independently driving economic activity. As the state is important in shaping the economic system it then becomes necessary to understand not just the state's role but its guiding ideology. It is in the field of institutional economics that the role of the state and ideology is analysed because this literature appreciates that the economy is not a separate entity but is influenced by both society and polity. As the institutional economics literature examines the economy, society and the polity it is said to provide a holistic analytical approach to understanding any economic activity including small firm formation. Key concepts from institutional economics likely to be of use are reviewed in the next section.



## 2.3 Institutional Economics: An Important Source of Concepts

Unlike neo-classical economics, which looks at the allocation and distribution of resources, institutional economics is concerned with looking at how the economic system is controlled and organised. As an academic discipline it does not have a long heritage, for it was first developed at the end of the 19<sup>th</sup> century in America. It came into being to correct some of the interpretations of what an economy is (Samuels, 1995). For example institutional economics has questioned the assumption in economics of the rational economic person with access to full information, making fully rational economic decisions<sup>14</sup>. The institutional approach to economic issues was most influential during the inter-war years in America, however, following the Second World War it went out of favour. There are a variety of reasons for this (see Rutherford, 2001), but one of the most significant is the increased importance of econometrics. In addition it no longer provided the only analysis of imperfect and monopolistic competition or market failure for neoclassical economics had by then developed its own theories on these issues (Rutherford, 2001). It was also criticised for being too descriptive and too empirical and hence unscientific (Foster, 1991) so that it eventually went into decline as an approach. This history partly explains the scepticism of some analysts about its usefulness. Consequently for much of the 20<sup>th</sup> century it was ignored. In the 1970s though it was revived and developed to analyse historical economic development and firm level behaviour, both of which have some relevance for this study.

This study predominantly uses the approach to institutional economics developed by Douglass North in the 1970s; but applied here to examine small firm formation in a transitional economy. North's 'new institutional economics' or NIE combines the original institutional economics approach of the founder Veblen within a neo-classical economics perspective. So North combined the institutional notion of evolutionary change (incorporating an understanding of the contribution of technological change, how individuals with their habits and interests create inertia and how change always entails some continuity) with the neoclassical approach of game theory, demand and supply theory and so on. The influence of neo-classical economics in the early days when North was



developing his NIE approach was explicit in his assertion that change would always lead to greater productive or allocative efficiency (Rutherford, 2001). North’s arguments though altered over time when it became clear to him that wholesale change need not always lead to improved efficiency because of the continued influence of old habits and beliefs guiding behaviour (Rutherford, 2001).

The application of institutional economics within a neo-classical economics framework divided the institutional economics approach into two traditions. This split was into ‘old’ institutional economics (OIE) (a tradition developed before the 1970s but which still has proponents working on it) and ‘new’ institutional economics (NIE) (a tradition developed after the 1970s) (Rutherford, 1994). Differentiating between OIE and NIE is a difficult task because researchers engaging in either approach will often make use of and adapt concepts from the other approach. Figure 2.1 below is an attempt to differentiate between ‘OIE’ and ‘NIE’ but because isolating these factors is complicated by the way they have been used in the literature, it remains a rough guide.

Figure 2.1 Institutional Economics – Summary of Approaches and Key Concepts	
Approaches	Features/Key Concepts
OIE (Hodgson) (Veblen)	1) Emphasise habits influencing behaviour. 2) Ways of thinking – conventional behaviour. Actions embedded in the customs of a society. 3) Regulative – imposes form – collectively devised. 4) Path dependency – change is cumulative, that the past influences the present and the future.
NIE (North) (Williamson) (Eggertsson) (Furubotn)	1) Rules of the game – humanly devised by individuals (in control) influencing behaviour. 2) Rational individual decision making behaviour. 3) Individuals influenced by the collective (sometimes). 4) Structure interaction – set parameters which are both restricting and facilitating. 5) Transaction costs and property rights – core notions.

(SOURCE Rutherford, 1994, 2001; Hodgson 1994, 1998)

In figure 2.1 one of the main factors in OIE identified as important, is that economies develop in an *evolutionary* manner (*path dependent development*) so that the past affects the present and the future. OIE also emphasises the importance of *habits* (conventions) and routines on behaviour, the slow manner in which they change (because of traditional ways of thinking) and the effects they have on new institutions such that they may not work in the manner they were designed to. The



NIE literature uses as key ideas main stream tools of economic analysis especially *transactions costs* and *property rights*, whilst rejecting such elements as perfect information and autonomous individuals. There is also an emphasis on the role of the *state* (and the *ideology* that drives it) on creating the institutions and on the nature of *enforcement* measures. This study combines concepts from the two approaches in institutional economics because together they can contribute to a deeper understanding of any form of economic activity. The concepts considered useful to this study will be evaluated in this section. But first there has to be an understanding of what an 'institution' is in this literature and what influence it has over economic activity such as small business formation.

There have been many different definitions of what an *institution* is. As with the entrepreneurship literature it often depends on the academic discipline within which the research takes place. As this research is looking predominantly at small business development from an economics perspective the definition will be drawn from that discipline. One of the simplest, clearest, and much used definitions of institutions within the new institutional economics is that of Douglass North (Clague, 1997a). He uses the term institution to emphasise the regulative aspects where institutions are the 'rules of the game' which have been devised by humans to shape human interaction (North, 1991a). Some analysts such as Clague add to the definition, often to make it fit more precisely the phenomenon under study<sup>15</sup>. This project though will use the simple definition by North. Institutions are regulative because being the rules of the game they set the parameters within which economic activity takes place. Rules are both liberating by creating incentives to act (because individuals can predict what to expect of others) but also restricting, by preventing certain activities from taking place. An important theme in this study therefore, will be explaining the institutional arrangements. In other words the formal and informal rules of the game or institutions (that create the opportunity or incentive structure) in Russia and specifically in the Rostov region (throughout the historical periods of this study) that are most relevant to new business formation and survival will be examined.



### 2.3.1 The Formal and Informal Institutions or Rules

Institutions according to North are the ‘rules of the game which then have to be divided up into *formal* and *informal rules*. Formal rules are for example rules of law, statutes, constitutions, courts, government regulations, monopolies legislation, taxation, contract laws and so on. These rules regulate economic activity, and though they may appear to have existed for centuries, usually they have changed incrementally or very gradually, reflecting the situations they are controlling and the influence of the elite that devise them. Thus the potential entrepreneur or small business founder, both in 1990s Russia and further back in the past, would have had to assess the extent to which formal institutions (or rules) would support the formation of a small firm and govern the nature of its operation. In this way institutions provide the incentives that shape the kinds of small firms that are formed (Morrison, 1998). In addition it is necessary to understand what in turn shapes the rules or institutions themselves, for they are not static. North has shown that it is the governing bodies of nation states that devise and change the formal rules (North, 1991a). *Ideology* has an important role to play here, as it underpins the belief systems that are used when decisions are made. Consequently ideology informs the way the rules (institutions) are devised and revised by governments.

As rules are devised by the governing classes there is a tendency for the status quo to be preserved so that change only occurs when it is to the advantage of this class. The 1990s in Russia were the first years of significant systemic change. Systemic change implies fundamental changes to the basic institutions or rules which previously were necessary for the operation of a planned economy to those that are more suited to a market type economy. To a greater or lesser extent, the already existing institutional structure (or rules) will be difficult to change, not least because of familiarity with them and the way they inform habitual actions. Economic behaviour will reflect not just the existing institutions or rules inherited from the Soviet period, but also the new rules. These new rules may have been implemented to work in conjunction with the old rules, or they may have been adjusted in response to prevailing habits and routines to fit in with pre-existing rules, with the



consequence that they do not operate optimally. This study will examine the changes to institutions (or rules) and whether and how they have influenced small firm formations. Following North's ideas one should expect that change has been incremental rather than radical and that it will cause the least damage to the benefits the governing class receives. This needs to be appreciated, because lack of real change may mean that the opportunities for new small business formations are more restricted than one would presume they would be as the result of an (apparent) fundamental systemic change that occurred in the 1990s.

Formal rules need to be enforced and there have to be structures (police force, regulatory agencies, court systems, lawyers, judges, prisons (Yeager, 1999)) to carry this out. Furthermore, these *enforcement structures* have to make judgements that are both fair and consistent if the institutions are to encourage positive or wealth creating economic activity. Enforcement also relates to respect that exists for the law and the extent to which individuals abide by the rules of that society (Yeager, 1999). An ethical code will help to reduce the cost of enforcement, as it compels individuals to abide by the rules. Literature on small business formation in the Soviet and post-Soviet periods will provide evidence on the extent to which the law was respected and the way businesses abided or flouted the rules. The flouting of rules is partly influenced by ambiguity in legislation, which creates uncertainty and more importantly loopholes that can be exploited by those in the enforcement structure or other economic agents, (North, 1991a; Yeager, 1999). Thus the creation of new institutions (legislation) and enforcement has the potential to be detrimental as well as positive for small firm formation.

If the rules or institutions are perceived as unfair and enforcement is weak, then opportunities described by North as being in 'pirate' or criminal activities may be taken up if they are considered more lucrative than legitimate business. In other words the informal economy will appear more attractive (Yeager, 1999). This study consequently will need to understand not just where the opportunities exist and why, but also how the new institutions or rules are creating these opportunities. One could assume that opportunities must be more visible in post-Soviet Russia,



because of the systemic change that has already taken place. Yet if, (as in many less developed nations (Yeager, 1999)) the rules continue to be highly restrictive, or the new rules lack legitimacy or moral authority and if demand for services and goods still exists, will small firms still form in the informal or formal economy<sup>16</sup>? Will there be evidence that the new rules are too restrictive, not respected or easily evaded? This, however, only applies to the formal institutions there are also informal institutions which also influence economic activity.

*Informal rules* or institutions are more abstract. They have been termed folkways<sup>17</sup> (Scott, et al, 1997) and include for example codes of conduct, customs, shunning, standards of honesty, integrity and conventions (Williamson, 2000). They are hidden, unwritten rules, which are inherited through the ages and change as society changes (Foss, 1995). These rules vary spatially between nation states, regions and localities (Pejovich, 1995). For example there are different attitudes to work and work ethics in Germany and Montenegro; attitudes to single motherhood differ in France and Turkey. Unlike formal rules the informal rules do not change by fiat but incrementally or gradually as society restructures and culture changes. They are important to understand, for they can reinforce or undermine formal rules.

In this study it is important is to understand whether and how social attitudes to independent small business owners have changed in Russia, from considering them as illegal and exploitative in the Soviet period to being accepted in the post-Soviet period. This study does not aspire to ask questions about an individual's feelings towards small business; rather it will use secondary literature (for example academic surveys and analytical reports) as well as aggregate statistics to determine the legitimacy of independent small business activity. If small business is not socially accepted, then it should not exist on a large-scale in either the formal or informal economies. If the reverse is the case, then a substantial number of existing firms and a constant stream of new formations from a variety of entrepreneurial sources may well be evident in either or both economies. In addition if attitudes to business are still in transition, then some groups or individuals may be inhibited from entering business because it may still seem to lack respectability.



Institutions can be more than the rules of the game for they are often used colloquially to mean *organisations* (Schiavo-Campo, 1994). Organisations, are not institutions in the OIE or NIE literature. They are simply made up out of people<sup>18</sup>, who come together to fulfil some common objective (Hodgson, 1998), but also develop and implement their own rules (or institutions), such as codes of conduct for behaviour, dress, bonus systems and so on (Yeager, 1999). Examples of organisations include political bodies, businesses, regulatory agencies, city councils, churches, clubs and educational bodies (North, 1991a).

The political and institutional framework not only directly influences the numbers and the kinds of small businesses that exist, but are themselves changed by these organisations as they try to achieve their objectives (North<sup>19</sup>). In other words there is a symbiotic relationship between institutions and organisations that is mutually influential (North, 1991a,b). This study will to some extent examine the influence of new small firms on the rules or institutions that existed in Russia in the 1990s by establishing whether they have changed. Change, influenced by the development of new small businesses may have altered the way the large previously state-owned enterprises operated in the new post-Soviet market compared to the Soviet period. For example they may have developed strategies to reduce this new form of competition (by monopolising certain markets), which then alters the economic environment and may then necessitate the state changing or creating institutions to protect the operation of the market.

### 2.3.2 Institutional Economics and its Analytical Approach: The Role of the State and History

As institutional economics is essentially looking at regulative devices controlling economic activity, it is essential that the *state*<sup>20</sup> which sets and enforces the rules is analysed (Clague, 1997b). It is the state's main role to create an institutional framework that facilitates the exchange of goods and services (Yeager, 1999). The influence of the state therefore is fundamental in institutional



economics unlike neo-classical economics, which practically denies the state having any influence on the economic system (Clague, 1997b).

The role of the state in setting rules was particularly evident during the Soviet era. The economic system operated by the plan set by the politburo or politicians running the state. Under the new economic order of a market economy the role of the state has had to change to allow the market to operate (Hare et al, 1999). Some analysts in looking at both Russia and other countries in Eastern Europe have considered that this should entail the wholesale rolling back of the state from economic interference (Hare et al, 1999). They argue that the dire circumstances nearly all these economies were in at the end of the Soviet period showed that the state was not up to the task. The state by designing the rules provides the parameters and incentive structure for all economic activity and this means that the wholesale withdrawal of the state (irrespective of its past record) is impractical. The only way to improve the performance of economic activity is to restructure the political institutions (Yeager, 1999) and redefine the role of the state (Hare et al, 1999). For Russia creating a market economy entails reducing state intervention and ownership of industry, but also fundamentally changing the way it manages the economy. How the state in Russia managed the economy during the 1990s will have affected small business formation. If the state was able to create macro economic stability (for example stabilising the currency and creating a consistent and fair industrial policy) then all business, including small business should have been encouraged to develop. There are though, other rules or institutions that affect the day to day operation of businesses for example, registration, licenses and taxation. In Russia many of these institutions did not exist before the 1990s and if they did, they had to be adapted to operate efficiently in a market as opposed to a planned economy. By examining these institutions (with others that are in the process of being implemented or changed to suit a market economy) and the effect they have on the incentive or opportunity structure facing small business owners, it will be possible to determine the extent of their influence.



Transformation involves fundamental change to political and economic institutions, but these changes, according to research in the institutional economics literature, is more *evolutionary* or gradual rather than sudden. Institutional economics terms this a *path dependent* or path shaping approach to economic analysis. Path dependency exists because of the influence of culture and belief systems on the way institutions or rules operate. *Culture and belief systems* are passed on through the generations; they inform an individual's habits, moreover these belief systems have largely been shown to change slowly, more slowly than change to formal institutions. All individuals, whether they are part of the state apparatus or not, are born into and encultured by their societies (Hodgson, 1998). Moreover, the way individuals interpret institutions is based on previous experience, habits and understandings and this means that despite alterations to institutions the pre-existing rules are likely to be perpetuated to some degree because of these entrenched habits or understandings. Consequently the historical economic development of a nation state will tend to have a stable trajectory and this can provide insight into whether new or changed institutions are likely to operate as intended.

Understanding economic activity in Russia during the 1990s needs to be considered within its historical and cultural context (Hodgson, 1999). The reason for this can be simply illustrated. It is only by looking at history that it is possible to understand the reasons for the variations that still exist between the different market economies in the West. Culture and belief systems of the past influence how institutions are interpreted creating variation between nations. Consequently institutions exert a long lasting influence on any economic activity including small firm formation, by shaping the choices taken or opportunities available (North, 1991b). For this reason it is necessary to go back to a period where independent small business did exist to examine what governed the numbers of small business and also the way that they operated. Doing this should contribute to increased understanding of the development of small firms subsequently and the legacies inherited into the 1990s.



As noted above the reason for looking at the past is that change evolves gradually making the influence of the past long lasting (North, 1991a,b). Slow change happens in part because subjective individuals that form the governing apparatus shape the rules or institutions. Those who create the formal institutions tend to ensure they benefit from them (Yeager, 1999) and dislike change that will in any way be detrimental to them. Combining this with the way past institutions have shaped *regularities of behaviour (habits)* and *routines* tends to create resistance (or inertia) and even the potential for sabotage against change (Yeager, 1999). Smith and Swain comment that change is neither entirely voluntary by agents nor is it entirely structurally determined<sup>21</sup>. Thus the institutions of yesterday act to restrict the implementation of new rules, both in the present and in the future.

New political and economic organisations need to be created to break the old rationality inherited from the previous environment. This needs powerful economic agents for whom the old rules have become restrictive. A complete break from the past, which may be beneficial in the short run, could create new problems by being outside of known experience and historical traditions, and subsequently may prove more restrictive than a gradual change (Grabher and Stark, 1998, 1992). Irrespective of the kind of change that occurs both agency (organisations and individuals) and structure (the rules or institutions) are as important as each other, for institutions and human action are moulded by one another. The fact that the bureaucrats and institutions from the old system are inherited into the new one is the principal reason why apparently revolutionary change appears to be less revolutionary than its rhetoric. North<sup>22</sup> writes that all institutional structures have a built in set of constraints, which bias future choices and restrict the nature and extent of change. It is for this reason that Kagarlitsky has argued that what is happening in Russia is a repeat of its historical past, especially of the early years of the 20<sup>th</sup> century. Russians therefore are ‘creatures of the past and incapable of new beginning’ (Kagarlitsky, 1995). This theme and its relevance for new firm formation will be examined in chapter six.



One of the biggest problems in Russia during the 1990s was corrupt bureaucrats or state officials. *Corruption* has the potential to restrict change for all the reasons noted above. Therefore this study needs to examine the historical legacy of bureaucratic corruption from the past through to the 1990s and how it affected new small business formations. Corruption, according to institutional economics, exists for three reasons, it is rewarding, there are few chances of being caught and punished by the formal *enforcement systems* and the informal institutions do not sufficiently condemn it. Bureaucratic corruption occurs when government officials have the authority to set policy or ration resources to favour one group over another. (Institutions then have the potential to be bad or good depending on whether or not the incentive system they have created discourages corrupt practices or encourages honest economic activity). Corruption can (if it is endemic) become accepted as 'normal' by the informal institutions of some societies, which means social acceptance may perpetuate it, making change (for example that would help small business formation) unlikely to occur (Yeager, 1999). In a sense, the acceptance of corruption in a culture provides an economic rationale for the way individuals behave (Peet, 1997). Nonetheless the experiences of the Third World show the detrimental effect that corruption can have on economic development. Here corruption occurs when policies suddenly change, often without prior notice (Clague, 1997b<sup>23</sup>.) and bureaucrats have discretion in the manner they apply regulations (Yeager, 1999).

The existence of corrupt public officials, an ineffective public administration (Fukuyama, 1995) and an inadequate enforcement system are also linked with low levels of *trust* in a society. Such low trust societies, argues Fukuyama, are characterised by low social capital which he terms as having low spontaneous sociability or put more simply, societies where individuals are less likely to associate voluntarily with non-kin in groups that are non-governmental organisations. This means that they have less opportunity to develop widespread inter-personal relationships. According to this research another feature of low trust societies is that they tend to have experienced periods of centralisation, where potential rivals for power have been suppressed. As humans are social animals and if joining voluntary organisations is prohibited, the only kind of non-state or independent organisations to develop will be criminal. Societies with low levels of



'generalised inter-personal' trust may then be described as having experienced centralisation, have corrupt officials, criminal groups and lack voluntary organisations. Russia in its distant and more recent past shares many of these characteristics, and according to Fukuyama's argument it could be termed a low trust society which has potential consequences for new business formation, a theme developed in the analytical chapters.

Low trust societies need effective laws, contracts and enforcement systems if business exchange is to take place<sup>24</sup>. Developing such institutions according to Fukuyama imposes an additional tax on all economic activities because it is costly in time and money. Unfortunately for Russia the legal and enforcement institutions inherited from the Soviet era into the 1990s, when it was developing a more laissez faire market type economy, are unlikely to be rigorous enough to encourage small firm formation and business transactions, when trust levels are low. Certainly this argument appears to be substantiated by the low levels of small firm formations that Russia has experienced during the 1990s. It could also be argued that low levels of trust combined with less than suitable institutions will not necessarily prevent small firm formations, but will shape the kind of business relationships and business transactions they undertake. In low trust societies, one should expect to find that business relationships would be restricted to known and proven business partners, suppliers and sellers or be associated with criminal activities.

According to Fukuyama (1995), low trust societies are characterised by many small family firms but few very large firms and here he cites the examples of Southern Italy, and China. Large firms often have to be established by the state (because there is no incentive for small firms to grow into larger businesses) and will incorporate as much of the production process in-house rather than engage in business transactions with other firms. This has much in common with Williamson's (1996) work, which stresses that if transaction costs are high then services will be undertaken in-house (through vertical integration), rather than obtained through the market. There are implications here for small firm formation in post-Soviet Russia. Russia inherited from the Soviet period large former state-owned enterprises that have vertically integrated many core economic activities, and



sometimes also a number of unrelated economic activities as well. In a low trust society, these firms are unlikely to undertake radical restructuring that relinquishes too many of these in-house activities. This reduces the opportunities available to potential small firms to take over these activities. More importantly it suggests that in low trust societies the former state-owned enterprises will be less willing to adapt. This could prolong the whole transformation process, though for analysts such as Murrell this would not necessarily be a bad thing for it would give institutions and individuals time to adapt to the specific circumstances that exist (Murrell, 1993).

Trust is a very important element for any successful economy and will need to be examined. The problem facing Russia is how to establish the learned habit of trust in society during the transformation period, when in the past there has been little experience of it. The learned habits of business people, politicians, or the general public were established in the Soviet period, these are likely to be inherited into the kinds of business relations exhibited in the 1990s. These traditions and norms may be unsuited to a market type economy, especially as many were learnt in the informal economy and are not based on the kinds of appropriate ethical behaviour normally associated with market economies. Trust will need to be established in Russia and there are two ways that trust can be encouraged. The first and according to Fukuyama (1995) the most vital element is through spontaneous sociability (involving non-kin trust in spontaneously formed non-state organisations that make up civil society). Only through spontaneous sociability (with no state interference) does society obtain the learned habit of trust (by establishing generalised inter-personal relationships). This takes time to occur, and will not emerge immediately on retreat of the state. Another way to improve trust levels in society is to by preventing state bureaucrats from engaging in opportunistic or corrupt practices. Bureaucratic corruption allows some powerful members of society to abuse the formal institutions for personal gain which (amongst the population at large) increases distrust both of bureaucrats and the credibility of the state but it also weakens the legitimacy of formal rules (Yeager, 1999). Consequently if the government and its bureaucracy are not seen to be operating by the rules or institutions and enforcement is seen as ineffective in restricting this activity, then it is unlikely that other economic agents will feel compelled to operate according to the rules.



To understand economic activity institutional economics has developed certain analytical tools, some of which can be applied to understanding small firm formation. The ones that are more appropriate for this meso level enquiry are *transaction costs* and *property rights*. These analytical tools will be examined in the next section.

### 2.3.3 The Analytical Tools of Institutional Economics

Some analysts, such as Toye (1987), have argued that institutional economics does not provide new insight into how an economy operates. Although this is an understandable criticism, institutional economics does have some advantages over other analytical approaches. It acknowledges the role that the state plays in shaping opportunities for economic activity, it offers an understanding of how this occurs and encourages a fuller analysis of the consequences. In addition it combines variables from a variety of academic disciplines to create a holistic analysis underpinned by the belief that both the polity and society influence economic activity. Furthermore, there is an understanding that the present can only be properly understood if the past is also analysed. So although institutional economics may not provide any fundamental new information on what is shaping small firm formation during the 1990s in Russia, it does have the potential to contribute to a deeper understanding of it, just as it has about Third World economic development. This is because institutional analysis takes into account variables that are exogenous in other economic models, but which prove to be significant when explaining the behaviour of economies that have not developed along the western model (of democracy and market economy).

Apart from considering the role of the state, trust enforcement, habits/routines or regularities of behaviour and path dependency (or historical legacy) institutional economics uses four main economic tools for its analysis. Game theory and principal-agent theory are really only applicable to research conducted at the micro scale examining individual responses. *Transaction cost theory* and *property rights* on the other hand can be used at a meso level and are suitable for incorporating into the conceptual framework used by this study.



*Transaction cost theory* was developed by Williamson (Foster, 1991) based on Coases' 1937 theory. Transaction costs are broadly defined as the costs that are incurred when entering into an exchange of any form. They are the intangible non-market costs and include:- costs of searching (including time and effort), costs of information, bargaining or negotiating, decision costs, policing and enforcement costs (Furubotn and Richter, 1997). So transaction costs are always present, but if they are too high they can prevent a gainful transaction from taking place and become the cause of market failure (Khan, 1997). Although originally developed to explain vertical integration in organisation theory, North applied it to analyse the economic performance of nation states through history and it is this contribution that is of most interest to this study. Here the economic and social costs involved in establishing, maintaining or changing the basic institutional framework are determined (Furubotn and Richter, 1997). As high transaction costs inhibit exchange it follows that the lower they are the better for economic efficiency which should be a prime goal of the state (Yeager, 1999).

Widening the application of the transaction cost framework, beyond the original intention of Williamson (its originator), has opened it up to criticism (Datta and Nugent, 1989). Transaction costs are criticised for being an all-purpose tool that can be applied to analyse any economic problem, with the result, according to some critics, that this weakens its analytical power (Toye, 1997). Other critics consider that all transaction costs should be quantified if the framework is to be useful (Toye, 1997; Datta and Nugent, 1989). Unfortunately quantification is not always possible, when the costs are intangible. Trust is a good example of an intangible and unquantifiable cost that occurs in every exchange, even when contracts are used. Although the cost of trust is impossible to measure its qualities still need to be examined. The quality of trust differs as much between individuals from the same cultural background as it does between nations because it is dependent on individual belief systems, past experiences and expectations of honesty. Another example of an immeasurable yet important cost is the cost incurred by not producing or exchanging (North<sup>25</sup>). Although transaction costs may not always be quantifiable, they still need to be examined because



together with production costs (sometimes known as transformation costs) they have played a significant role in keeping many Third World countries poor.

The use of transaction costs to analyse the effects of changing economic systems is also considered controversial. Toye claims that analysts such as North who do this, are not looking at transaction costs but transition costs (Toye, 1997; Khan, 1997)<sup>26</sup>. Transition costs are unquantifiable political costs associated with the potential loss of power. They are though not the only costs; transaction costs remain important because a change in the economic system will nearly always affect general business practices, for example competition and marketing. Business needs to learn how to adapt and deal with these changes, which takes time and involves a period of uncertainty when transactions may not take place. This is similar to the situation business was in during the 1990s in Russia, though a segment of the small business sector was established from new. One could also argue that establishing a business is entering a form of exchange, whether or not the economic system is changing, because a cost is incurred through human interaction with local officials, business partners or customers and may reflect the influence of insider knowledge or connections. Without stable, predictable and enforceable formal institutions to reduce transaction costs in Russia in the 1990s there is the possibility the informal sector, often incorporating small-scale ephemeral activities, will expand as experienced in the Third World. The danger with this is that the informal sector tends to facilitate short-term wealth extraction and personal enrichment of the few involved, as against legitimate wealth creating business that enriches the whole of society (North, 1991a,b).

Transaction cost theory uses the analytical concepts of *bounded rationality* and *opportunism*. Bounded rationality does not mean an absence of rational behaviour or the presence of irrational behaviour, rather it means that the agent will never be fully informed about everything despite attempting to be (Furubotn and Richter, 1997). The agent in attempting to make a rational choice will face constraints such as lack of time, incomplete information, subjective past experience and



limited understanding so that a decision, though rational will always be limitedly so. This analytical concept, according to institutional economics rationale, is more akin to the real world than the idealised optimum choice, made by a perfectly informed and perceptive agent assumed in the neo-classical economic model. Decision-making involves a cost which is the difference between the actual (often perceived by outsiders as the imperfect) choice and the ideal or perfect choice. Such 'bounded rationality' may well be found to characterise new firms choices during the transition period of the 1990s in Russia when judged by outsiders (for example representatives of international organisations).

*Opportunism* occurs because individuals tend to 'operate in their own self interest and with guile to secure advantages for themselves' (Petersen, 1995). It includes lying, cheating, stealing, distorting disclosed information and attempting to deceive (Foss, 1995). Information, enforcement and monitoring can never completely cover all eventualities, which means there is always the potential for individuals to behave opportunistically. There is a danger here of under-socialising opportunism; it must be remembered that an individual need not routinely behave opportunistically in all transactions and that culture, co-operation, respect for authority and frequent repeat exchange in a business relationship can self regulate this form of behaviour by improving trust levels. Nonetheless opportunism or exploitation often happens when the parties in the transaction have asymmetrical information (North, 1991a). Potential small business owners, in unstable economic environments where change to institutions is frequent, are more vulnerable to opportunistic behaviour by others. This is because in such an environment it is more difficult to monitor the performance of others; institutions may offer inadequate protection and as in Russia in the 1990s there may be a limited number of other potential transaction partners. Even in difficult economic conditions opportunism can be minimised. Consequently opportunism as an analytical concept has the potential to provide a more nuanced explanation for the low incidence of small firm formation in Russia in the 1990s, or why it is that SMEs engage in short-term trading activities rather than in manufacturing, which requires more long-term investment.



The second useful analytical concept suitable for this study is *property rights*. The literature on property rights emerged in the 1960s and 70s with work by Alchian and Demsets (Clague, 1997b). Property rights are a 'bundle of rights' which an individual has over the use of 'an economic asset in the framework of a social system' (Stahl, 1997)<sup>27</sup>. They do not only concern rights over property such as land and buildings but also rights over products, brands, intellectual property and the use of the proceeds from the property including rents and profits (Clague, 1997b). As transaction costs are always positive then it follows that property rights, which have an impact on them, are important (Yeager, 1999). Property rights have to be sufficiently secure to encourage investment, which means that any threats to them may prove more damaging to business than high rates of taxation (Pejovich, 1995; Clague, 1997b)<sup>28</sup>.

A myriad of property rights exists; some are common to all economic systems. Property rights in all economic systems define the basic rights, duties and boundaries that exist over different types of assets (Clague, 1997b; Bromley, 1989). In the capitalist system an important property right is the freedom of any agent to enter a business contract, which will also be upheld and protected in a court of law. Poorly defined and ineffective property rights have been blamed for the low levels of investment in fixed capital and short-term attitudes to business investment in Third World countries (North, 1991a). Some analysts like Bromley argue that property rights are always optimal, if they are not then they would automatically change (Bromley, 1989). Evidence though from Third World countries shows that many countries there still suffer from inefficient property rights, which continues to create barriers for investment. Consequently an analysis of property rights throughout history and in Russia in the 1990s has the potential to contribute to a more nuanced explanation for the nature and extent of small firm formation.

Institutional economics provides a good analytical framework to analyse small business formation but it was not designed to be used specifically at the regional level. One approach in the literature on regional economic development (RED), the subject of the next section, applies an institutional framework to a regional or local perspective to examine *clusters* of small firms. The



advantage of using this approach in the RED literature is the link it has with the institutional economics literature. In addition this literature shows that regions, with certain characteristics, are more likely to have higher numbers of small firms contributing to their successful economic development, which is one reason why small firm development is promoted by international organisations.

## 2.4 Regional Economic Development

Some of the growing literature, from the disciplines of geography and regional economics, attempts to explain, why small firms in some regions have not just been successful, but have also made a major contribution to the economic success of their region. These successful regions usually cited in the literature tend to be located in the West, for example Baden Wurtemberg, Emilia Romagna and the Basque Country. One school of thought in regional economic development (RED) concerns itself with the regulatory elements that have a significant impact on a region's development and especially on how they affect small firms. As a result this literature can be described as being institutionalist. This literature shows that regions are able to improve their competitiveness if they devise good regional institutions and make use of the region's local assets (Amin, 1999). This literature also emphasises the importance of *proximity*, which allows for *clustering* of small firms to happen so that improvements can be made to inter-firm co-operation and interaction with support organisations. This close interaction between firms, support organisations and the regions regulatory apparatus induces *learning*, which creates a flexible economic environment. It is this that helps to shape the opportunity structure and the levels of risk, which were discussed in the entrepreneurship literature. This literature also acknowledges the importance of societal and *cultural* influences and fully acknowledges that an economy is socially embedded and constantly evolving. All these are terms have already been discussed in the institutional economics section, making the continuity between the two literatures apparent. Although there are many similarities in the terms and ideas between the two literatures, there remains one important difference. The RED literature highlights the region as a specific and distinctive setting, in other



words space (proximity) plays an active role in influencing all of the factors and processes that have already been discussed throughout this literature review.

This literature starts from the premise that place or space is important and is more than just the presence or absence of physical resources. Space is formed and given its characteristics through social, political, cultural and economic processes. Moreover whether the region comes into being through cultural or political processes has an influence on its development. If a region is formed through hegemonic state policy then this level of power will tend to direct the region's economic development, whilst regions that are developed through cultural processes tend to have more control over their own regional development. As a result power and where the locus of power is, (or in other words whether power is centralised or devolved) is one important factor.

Social processes such as the development of technology and diffusion may also have a significant impact on the political and economic processes. For example the technology of the Fordist era necessitated the creation of large factories of national importance with parameters formulated by national support policies. In the post-Fordist age, advances in technology and social processes encouraging the demand for a more individualistic choice in products and services meant that small-scale production not only became feasible, but advantageous too. Consequently post-Fordist national policy though still important was not always capable of addressing the specific needs of small firms in the regions. As a result a 'glocalisation' process occurred, where the power balance shifted from a national to regional level, at least with regards to supporting small firms (Swyngedouw, 1997). This approach in the RED literature acknowledges the importance of national regulations (rules or institutions) to provide the basic parameters for all economic activity. It also stresses that any regional institutions have to be apposite, to fit in with national level policies and objectives, if they are to be successfully implemented (Martin, 2000; Hudson, 1998). If they do not then there is little likelihood they will be successful, but if they do then they can add an extra level of support that is contextually more specific. This literature stresses that all regions (like nation states) develop differently as a result of regional culture, polity, society and economy, and these differences



directly influence small firm formation. Consequently regional policies, regulations and support for small firm development should ideally reflect inherent regional specificities (Amin, 1999)

The regional context and its influence on past and future economic development are important factors in Herrschel's work. Herrschel examined two regions within the former German Democratic Republic, which like Russia operated under a planned economic system governed by socialist principles (Herrschel, 1997). He was particularly interested in how a region and its industry copes with a change to the economic system, when the previous socialist policy of creating self sufficient regions had introduced some forms of industry into the region, irrespective of the locational potential to support it. Consequently modification to or replacement of the rules or institutions when the economic system changes may have a detrimental effect on the viability of some industries in some locations. So economic activities that were previously imposed on a region by state decree may not be genuinely embedded in the regional economy. Their survival in the post-socialist era may only be achieved through extensive state support. Other industries that were indigenous to the region prior to the socialist era have the potential to build on existing locational specificities to become successful. This is an important point that needs to be taken into consideration when choosing the region and sector in Russia for this study. If the economic sector chosen was indigenous to the region prior to 1917, when the USSR was founded, then there is more likelihood that small firms may be in evidence within it in the post-Soviet period. If this industry was state imposed during the socialist period (and unsuited to local natural resources) then it is less likely that small firms would have established in this sector during the 1990s.

Although the institutionalist perspective is apparent in the RED literature, it uses the terminology differently to the OIE and NIE literature. The way the terminology is used and defined<sup>29</sup> indicates that this approach in the RED literature is still in the early stages of its development (Martin, 2000). Some researchers like Martin retain the definitions from institutional economics, though he uses slightly different terminology when he differentiates institutions from organisations. For him, institutions are the *institutional environment* containing 'informal conventions', (or informal



institutions), and ‘formal structures’ (formal institutions), whilst organisations are the *institutional arrangements* (Martin, 2000). This way of using terminology may be beneficial in reducing confusion over whether organisations or institutions are being discussed, especially as colloquially the term institution is often used synonymously with organisation.

The term ‘embeddedness’ is also discussed in the RED literature, though Martin considers that it remains under-theorised, and used only to mean social embeddedness. Embeddedness according to Martin should be widened to include historical embeddedness, political embeddedness, cognitive embeddedness, cultural embeddedness and so on (Martin, 2000). As all economic activity is shaped by institutions, beliefs and the way natural resources are exploited, then creating more specific terms for embeddedness appears logical. Institutional economics also tends to use only social embeddedness, but although not explicitly using the terms listed above it does nonetheless still argue their importance. The only difference between the IE and RED literature is that RED examines the unique assemblage of these factors at the regional level.

Regions are important for sub-national space or scale provides advantages resulting from proximity, which small firms can successfully exploit. The way that culture and economic activity has evolved over the years in regional space means that there are inherent shared understandings and shared ways of operating, as well as factors distinctive to that region and conducive to successful business formation. Small firms can exploit this knowledge to reduce transaction costs when engaging in exchange with one another, something that may not be feasible when dealing with small firms from outside the region. *Clusters or networks* of small firms in many successful regions usually arise as a result of the frequency of exchange that has developed. Clustering arising from proximity creates two types of advantages: *agglomerations* and *untraded interdependencies*. Agglomerations or external economies help to compensate the small firm for its size and lack of internal economies. In regions with clusters of industrially related small firms, agglomerations of regionally specific assets develop such as a trained labour market, specialist suppliers, technological knowledge. Untraded interdependencies also develop in these regions but



they are less visible and include such assets as tacit knowledge, habits of inter-firm co-operation, trust and networking, shared norms and values, knowledge and learning (Grabher and Stark, 1998). Although Soviet Russian firms tended to be large rather than small, it is still important to discover the extent they were able to cluster and whether there was localised industry knowledge (derived from specialised industries and the linkages between them), that small firms formed during the post-Socialist era can exploit. Furthermore in this study it is important to look for evidence that small firms are trying to compensate for their size disadvantages, by creating some kind of 'cluster', where knowledge and information can be exchanged and whether a culture of co-operation is apparent. Clustering, and the advantages accruing from it, in post-Soviet Russia may differ from that found in many other parts of the world, but its existence would indicate that small firms have some potential to survive and develop.

The RED literature stresses that proximity by itself is not sufficient. There needs to be *support organisations*, operating at the level of the local cluster. Successful regions with a well-developed small firm sector tend to have a wide variety of locally based support organisations. All regions are different, so the kinds of support organisations they develop have to take into account these differences, in other words they have to reflect the traditions of the region (Kratke, 1999). Thus the institutions and support organisations created in Third Italy, the Basque Country and Baden Wurtemberg differ fundamentally to reflect the respective needs of small business. It is the combination of support organisations and the linkages between them and clusters of small firms, a tradition of collaboration and tailored regulatory framework that creates an *institutionally thick environment* (Amin, 1999). The thicker the institutional environment the more successful a region will be and also the greater the isomorphism or resemblance between firms.

Successful regions according to Hudson (1998) do not depend on external conditions, but depend on conditions and processes that are internal to the region. As a result he concludes that less successful regions can always 'do something' to become more successful. What they need are the right kinds of regulations and policies. This requires *forms of local governance* that create an



appropriate institutionally thick environment that is both enabling and facilitating. Unsuccessful regions tend to be locked into old institutional structures that are more relevant to earlier phases of (successful) economic development, but which in changing circumstances have become a barrier to new development. Developing an appropriate institutionally thick environment is not easy, it takes time and more effort than simply liberalising the macro economic climate (Cooke, 1996).

Regional governments keen to emulate the success of other regions should be warned against forcing culturally inappropriate institutions and forms of organisations on small firms, if they want success (Amin, 1999). Rather once clusters of small firms are apparent they should then design an appropriate institutionally thick environment to nurture their success (Amin and Thrift, 1995). Importing solutions may result in improvements, but the kind of success shown by the original region is unlikely to be replicated and indicates that regional governments have not appreciated regional specificities. Successful regional development is a 'bottom up' process and depends on building on and building up local capacity. This generally occurs through consultation between various regional actors to create inclusive, transparent and well-supported policies (Martin, 2000). It tends not to happen where solutions are imposed, no matter how charismatic the leader may be (Amin, 1999).

One major criticism of the regional economic development literature arises from its inability to provide a prescriptive solution and detailed policy guide (Lovering, 1999). Policies have to be tailored to a specific region's needs and internal assets. This though is also regarded as an important strength of the literature. 'Off-the-shelf' solutions are never entirely applicable, and regions wanting to exploit their full potential need to create policies that harness their specific internal assets, whether these are cultural, economic or a mixture of the two. What this literature does do is to provide examples of solutions already employed, and explains how these solutions were found as well as the kinds of factors that were present in the region for encouraging small firm formation. These examples then provide valuable inspiration and ideas to other regions looking for ways to improve their own economic development.



## 2.5 Conclusion

This review has shown that economic activity such as small firm formation, when viewed at the meso scale is likely to be the result of a host of factors, such as geography, resources, institutions, regional and state government, spatial proximity, social and industrial traditions and more. It is hard to say that any one factor is more important than another. Furthermore economic activity is not entirely dependent on the individual (the agent), nor the structure: they are mutually dependent on one another. Many of the factors highlighted in this review are common to the three bodies of literature others are not, justifying the review of the three literatures. This review has shown that all three literatures have a common orientation in the belief that economic activity is ‘socially embedded’. Therefore there is a core of key concepts that will be central to the conceptual framework, while other concepts in the literature will provide additional insights in a complementary way.

Figure 2.2 provides an overview of the bodies of literature and their related concepts that will be used to create this conceptual framework. The first column presents the source literature, which in this instance is:- the entrepreneurship literature, institutional economics literature and regional economic development literature. The second column records the concepts that have been identified in this literature review as being significant for understanding small firm formation in the 1990s. The third column briefly details their importance or impact, and provides a rationale for selecting some of them for inclusion in a synthesized conceptual framework that will guide data collection and structure the analysis of the substantive chapters.

Figure 2.2 also presents the concepts that are important from the literature. The literature on entrepreneurship has highlighted the nature of risk taking, opportunity seeking, the importance of the economic and social contexts, the role of culture, finance, industrial structure, availability of the factors of production, wage levels, market demand, taxation, the legitimacy of entrepreneurship in a society, the meaning of failure and the importance of mainstream and marginal social groups.



These come together to create both a demand for new firms and a supply of potential entrepreneurs.

The institutional economics literature acknowledges that these factors are important but it tries to understand what precisely shapes these factors through time and how this then determines the kinds of economic activities that exist such as small firm formation. This literature stresses the importance of the role of the state, ideology and society in shaping the rules of the game (or the formal and informal institutions) that provide the (dis)incentive structure (or opportunity structure) for new firm formation. It also shows that changes to policies or institutions (rules) happen slowly and incrementally (path dependency) partly as a result of habits of action and the importance of retaining the status quo. This may be so even in revolutionary periods. The literature stresses that the effectiveness of institutions is dependent on enforcement and the ease with which corruption can take place. The amount of exchange in the economic environment is influenced by the kinds of property rights that exist, which in turn influences the level of transaction costs. Exchange is seriously reduced when transaction costs are too high, and it is this that is said to keep Third World countries poor and unable to take advantage of the assets they have. High transaction costs are also detrimental to small firms everywhere but especially in nations where the state has done little to reduce them. Trust is another key concept, which if found lacking has the potential to be a negative influence on small firm activity.

The regional economic development literature takes the regulative elements of institutional economics, together with path dependency and the importance of culture, in shaping the economic environment. It though stresses, that the region is a unique space with inherent specificities that.



Figure 2.2 Summary of the Sources of Literature and Important Concepts

Source	Concept	Significance/Impact on New Firm Formation & Nature of New Firms
Entrepreneurship		
Economic Model	Risk Taking	What is the nature of financial and personal risk, how stabile is the economy, what is the nature of corruption and role of criminal gangs, does the level of risk encourage firms into formal or informal economy?
Sociological Model	Opportunity Seeking	How does competition, state interference and state policies restrict opportunity seeking?
	Opportunity structure	How does the context/structure (social, political and economic environment) shape activity/agency? Idea of economy historically, politically, socially embedded. How has context and activity of small firm formation altered over time and space?
Demand for Entrepreneurship	Culture	What is the effect of beliefs, morals and social groupings on entrepreneurship and small firm activity?
	Factors of production	What is the availability and expense of for example land, labour, finance, raw materials, transport?
	Industrial structure	What is the nature of indigenous industry for example, heavy and or light, whether it is large-scale, barriers to entry?
Supply of Entrepreneurship	State of the market.	What are the wage and demand levels? What is the level of domestic and foreign competition?
	Social groups	Where are the sources of entrepreneurship? Belonging to mainstream or marginal social group, social climbing or falling.
	Legitimacy of entrepreneurship	Is there high or low social acceptability for forming new firms (entrepreneurship), what is the attitude to failure within business ?
Institutional Economics		
	Institutions, formal/informal (Structure)	What are the rules of the game, formal include laws, regulations, informal are unwritten rules, include codes of conduct, moral imperatives, folk ways, shunning?
	Evolution path dependent development	Institutions change incrementally – the past influences the present and future, past institutions retain relevance and (path) shaping the future
	Transaction costs (bounded rationality, opportunism)	What financial and personal costs are involved in adapting to new regulations, finding suppliers, sellers, and information? What is the role of social networks, and connections in reducing high transaction costs? How do they determine whether opportunities are taken up
	Property rights	Rights of individuals regarding ownership, use and transfer of assets. Will secure rights determine whether opportunities are taken up?
	Culture and belief systems (Agency) including trust	Development of learned habits or regularities of behaviour determine trust. Are they influencing the way people understand, adapt and react to new institutions/rules and take up opportunities?
	State, state ideology	Those in control shape the institutions and tend to preserve status quo – Is the state perceived as facilitator or inhibitor?
	Organisations	Small firms, what role do small firm support organisations both indigenous and foreign play in encouraging small firm formation?.
	Enforcement.	How Efficient and fair are the judicial/ police systems, are powerful individuals or state also successfully restricted by the law?
Regional Economic Development		
	Local assets	How has industry developed in a locality (history), and what influence did resources, infrastructure, relative location have on it?
	Proximity and clustering	What opportunities exist for co-operation, agglomeration (specialist suppliers, trained labour market, technical knowledge), untraded interdependencies (tacit knowledge, trust, networking, shared values, norms)?
	Regional political structures	Where is the locus of control for the region. Devolved or national control, active regional government?
	Institutional arrangements	What regional specific organisations support small firms, is there an institutional thick environment?
	Institutional environment	What are the regional rules/regulations affecting small firm formations?.



have emerged as a result of being shaped by its unique social, cultural, historical, economic and political processes. The regional government is a facilitative or enabling entity; in successful regions it consults with other actors to produce policies that are most suited to the environment and that will facilitate small firm formation. It acknowledges that small firms benefit if they cluster together in close proximity to take advantage of external economies and untraded interdependencies. Moreover consultation and clustering can lead to a successful 'bottom up' strategy which improves the competitiveness of small firms. All these factors have been shown to affect the extent of small firm formations but also the nature of their operations, exactly what this study is attempting to address.

The next chapter takes these concepts from the literature and organises them into a conceptual framework to analyse small firm formation. The framework will group the key concept to avoid repetition creating a simpler operational model for the analysis.

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### End Notes

<sup>1</sup> What is or is not entrepreneurial remains a controversial issue in small firm research. For Carland et al (1984) there is a distinct difference between entrepreneurs and small business owners. He considers that it is only entrepreneurs who intend to grow their firms with the aim of increasing profitability. Small business owners on the other hand tend to establish businesses for a variety of personal goals or reasons, and the business tends to be a primary source of income. For other researchers such a classification is not so straightforward. This is because some entrepreneurs may have personal goals just as some small business owners may have a real desire to increase profitability (Fadahunsi, 1997b; Smallbone, 1999a).

<sup>2</sup> Research into entrepreneurship has been made more difficult because each researcher uses his/her own definition. There is no universally accepted definition of who is an entrepreneur and which activities are entrepreneurial (Hornday, 1992; Shaver and Scott, 1991; Morrison, 1998; Binks and Vale, 1990). Scott writes how one research department tried for over ten years to define the entrepreneur but never succeeded in reaching an agreement 'despite each researcher having some notion of it' (Scott, et al, 1997).

<sup>3</sup> Morrison describes how social contexts are important. Individuals are described as going through personal transitions often linked to the life cycle, which influences their changing goals, needs and ambitions. Other factors which influence them are external events, the value systems of their society, earlier formative experiences and personal characteristics, work is also influential as are occurrences of unemployment, and family attitudes amongst others. She also writes that entrepreneurship is an action which may be triggered on and off in some people and is not necessarily a once and for all occurrence (Morrison, 1998). Landes, who studied French entrepreneurship considered that it is not just down to the individual although (s)he has some influence. Entrepreneurial activity in his opinion is shaped by outside factors such as geography, resources, population movement, law and government, social traditions and so on (Landes, 1949).

<sup>4</sup> Social processes shape the nature of entrepreneurship. Despite similarities between entrepreneurs in Europe, social processes (resulting from different national contexts) have shaped the variation in entrepreneurship that exists and the way it is exhibited (Curran and Burrows, 1987).

<sup>5</sup> Harris comments that the perception of an opportunity is important only if information about opportunities is limited and imperfect (Harris, 1973). Opportunities are often imperfectly perceived, as individuals tend not to view them accurately. In economic terminology individuals suffer from bounded rationality, they possess biased information, obtain information through poor communication channels and are also influenced by society (Aldrich and Zimmer,



1986). This makes opportunity a relativistic concept because the perception of an opportunity and whether to take it up alters (for individuals) depending on time of life, previous accomplishments, financial resources and social milieu. Stevenson and Sahlman define opportunity as a function of an individual's own upbringing, perception of possibilities, sense of right, justice and need for fulfilment as well as social barriers, which if too high will prevent opportunities being sought (Stevenson and Sahlman, 1991).

<sup>6</sup> Herron writes that entrepreneurship takes place in society and is shaped and fashioned by the social context (Herron et al, 1991).

<sup>7</sup> Long investigated the central highlands of Peru over months and years (Long, 1979) and Barth, investigated small-scale entrepreneurs in an area of Northern Norway, (Barth, 1972).

<sup>8</sup> Entrepreneurship is a social role visible in all societies; the form it takes though varies in correspondence to the social context. (Bridge, 1998).

<sup>9</sup> Fadahunsi shows that entrepreneurs are not passive recipients of opportunities but active participants who process information and strategise their dealings with various local actors, institutions (here meaning organisations) and personnel (Fadahunsi, 1997b).

<sup>10</sup> Cultural mindset is an informal institutions (including the norms and traditions that have been shown to have either an inhibiting or facilitating effect on entrepreneurship) (Stewart, 1991). Morrison writes that entrepreneurs are to an extent products of their society. They engage in entrepreneurship in response to a situation or events (see note 3 for some of the factors).

<sup>11</sup> Dana (1995) writes that some groups are more entrepreneurial than others. Shapero and Sokol (1982) state culture used to be an explanatory variable for both the existence of entrepreneurial activity or the lack of it. Consequently some cultures were depicted as valuing entrepreneurship (for example the Ibos in Africa, Parsis in India, Jews and so on) more than others due to religious beliefs or in the case of Laos because Soviet styled communism had created a non-entrepreneurial society (Becker, 1956). Although ethnic immigrants have often been considered entrepreneurial, some authors suggest that rather than looking at ethnic background for a predisposition (or deterministic conditions), it would be more beneficial to examine the situation or general social context into which they have arrived for the true influences (Aldrich and Zimmer, 1986).

<sup>12</sup> This belief in the power of the market and its ability to improve economic activity just through releasing constraints was transferred to post-Soviet Russia. Smith and Pickles show that western belief in the power of privatisation, liberalisation, democratisation and stabilisation to create a self-regulating market economy was seriously under-theorised. They argue that this belief failed to take account of the complexity of transformation, which encompasses wholesale changes to the polity and society as well as to the economy (Smith and Pickles, 1998).

<sup>13</sup> The values of a classical socialist system incorporated social justice and equality, in addition there would be no exploitation of individuals. In this way socialism was understood to be a morally superior system to capitalism. A national economic system is fundamentally shaped by an ideology like this which permeates society and contributes to influencing moral attitudes (Kornai, 1992).

<sup>14</sup> Firstly individuals do not always have access to full information, and make decisions on the information they have available (bounded rationality). Secondly, they are influenced by family, taste, habits, time of life and work when making their economic decisions. Thus whilst individuals may make rational decisions based on their own circumstances, these decisions may not appear to be rational to economists.

<sup>15</sup> Clague adds that "the emergence and evolution of these rules is understood in terms of the motivations and decisions of the individual actors in the collective" (Clague, 1997a).

<sup>16</sup> Pirate economy here will be taken as referring to the informal, black, second, shadow, underground, counter, unofficial or parallel economy.

<sup>17</sup> A traditional social custom – a way of thinking, feeling or acting common to people of social group (Longman English Dictionary, 1992).

<sup>18</sup> Organisations emerge to administer and enforce institutions or the rules of the game (Schiavo-Campo, 1994).

<sup>19</sup> Undated internet essay, 'Institutional Change: A framework of Analysis' (North, D.).

<sup>20</sup> The state is the bundle of government institutions that define and implement national policies (Mcfaul, 1995).

<sup>21</sup> Economic institutions do not arise automatically but are socially constructed (Smith and Swain, 1998). A view supported by Amin and Thrift, who in addition argue that socio-economic processes are embedded in time and space. "The economic life of firms and markets is territorially embedded in social and cultural relations and dependent upon processes of cognition (different forms of rationality), culture, different forms of shared understanding or collective consciousness, social structure, networks of interpersonal relationships and politics, the way in which economic situations are shaped by the state class forces" and so on (Amin and Thrift, 1995).

<sup>22</sup> Undated internet essay, 'Privatisation' (North, D.).

<sup>23</sup> Clague comments that there is often no reconciliation between the new and old decrees (Clague, 1997b).

<sup>24</sup> Business exchange is made easier with trust as the individual parties believe in the need to honour agreements. In all modern societies where there are arms length transactions trust does not negate the need for contracts and laws, trust simply reduces the need to hedge for contingencies, there will also be fewer disputes and less need for litigation. Trust also eases the process of finding appropriate buyers, sellers, negotiating contracts, complying with regulations, and enforcing contracts (should there be a dispute or an incidence of fraud) (Fukuyama, 1995).

<sup>25</sup> Undated essay, 'Institutions and Productivity in History' (North, D.).

<sup>26</sup> Transition costs are associated with the actions of political actors when changing institutions, namely their resistance to change (in other words the way they select only those institutional changes that for them would be less painful). It is not associated with imperfect knowledge. Transformation costs are costs incurred during production itself (Khan, 1997).

<sup>27</sup> Schiavo-Campo writes that "property rights refer to the effective power of individuals to control scarce resources and enjoy their valuable attributes" (Schiavo-Campo, 1994).

<sup>28</sup> People are more likely to take better care of their own homes than rented homes, over which they have fewer property rights (Pejovich, 1995).

<sup>29</sup> The terms where confusion arises due to differences in definitions include:- institutions, institutional thickness, social embeddedness, networks, and governance (Martin, 2000).



## **Chapter 3**

# **The Construction and Application of the Conceptual Framework to Understanding Small Business Formation**

### **Chapter Outline**

This chapter creates a framework incorporating the salient concepts/variables from the various literatures explored in chapter two, which have been found useful for analysing small firm formation. This framework will be used to organise the explanatory narratives in chapters four, five and six. The framework includes a classification of the variables under broad categories, which after having been operationalised indicated the research methodology that should be employed for the collection of data, namely both interviews and secondary literature. As this research is concentrating on examining a particular phenomenon that is undertaken in a small region of Russia, a case study approach allowing for the use of these multiple research methods was adopted. The region for this research is Rostov oblast, which having a comparative advantage in agriculture was considered to have a greater potential for providing more opportunities for small firm formation in the food-processing sector. In examining the regional peculiarities of Rostov oblast there is a discussion of its geography, industrial background and the historical development of manufacturing.

## **3.1 Introduction**

The previous chapter reviewed three different literatures that were chosen for their capability of analysing small firm formation. From these literatures various specific concepts that were particularly useful were obtained (see figure 2.2 Summary of the Sources of Literature and Important Concepts in chapter two for an overview). This chapter takes these varied and sometimes duplicated concepts or variables and places them into a framework. To use the concepts/variables effectively they were all placed under one of three broad categories and were then operationalised to decide not only how to judge their presence, absence and intensity but also to determine the research methods to be employed when applying them in an explanation. A further consideration was that unlike many other studies on small firm formation this inquiry was not a micro or firm level investigation. This research was designed to investigate small firm formation at the meso or sector level which itself was in response to theoretical and methodological considerations. In other words it



was designed to avoid overplaying the significance of variables at the micro level for individual firms that need not be common to all in a sector whilst also not underplaying their significance, which might be an issue for an aggregated study at the macro level. The meso level was also considered appropriate for this research because of time restrictions in the field, where it was also anticipated there would be difficulties in contacting small firms. The result was the employment of a methodology that uses historical data in the form of secondary literature and aggregate statistics as well as generating some primary data from key informant interviews.

Apart from conceptual and methodological considerations, this chapter introduces the research area of Rostov oblast. This region was chosen for its agricultural comparative advantage, which should be beneficial to small firms establishing in the food-processing sector with regards to ease of finding inputs (labour and raw materials in particular). In addition this region by having a varied industrial structure and a large urban population had the potential, during the transition process, not only to limit the levels of unemployment but also to sustain a certain degree of consumer consumption of processed food products.

### **3.2 The Conceptual Framework**

The purpose of this section is to incorporate the bodies of literature examined in chapter two into a framework that can be used to comprehensively analyse small business formation in the food-processing industry within a specific region, in this case Rostov oblast. Before constructing the framework, one issue needs to be clarified, and that is the appropriateness of using western literature to explain an economic activity in a region that has followed a non-western path of economic development.



There are a variety of arguments supporting the use of ideas from western literature in examining non-western development paths. The first set of arguments support the use of institutional economics, and the second set of arguments the use of the regional economic development literature. It can only be stressed that institutional economics, which for this study is a main source of concepts, has been used successfully to investigate non-western countries (see Olson et al, 2000). Certainly institutional economics (IE) applies concepts and analytical tools developed in main stream economics, but by stressing the influence of the polity and society in shaping economic activity, its analysis is always from the perspective of the culture under investigation. This plus the acknowledgement that history (distant and near) is also influential helps to reduce the chance of producing an ethnocentric analysis. Consequently for this study to understand the way economic policy was shaping small firm formation in the 1990s, it is essential to examine not just how the economy, polity and society operated in the 1990s, but also how they operated under previous economic systems. The institutional economics literature though does perhaps under-theorise the regional scale of analysis by not being regionally specific. Supplementing it with some of the related literature from regional economic development was one way to provide additional sources of concepts and it also provided this regional element that would otherwise be missing.

The regional economic development literature (RED) has predominantly been applied to understanding small firm success within regions in the developed West. These regions include some with initially low levels of development, and it is here there is some comparability to the situation in Russia, though in Russia the degree of underdevelopment is more acute in many regions. Nonetheless this literature has shown that regions with low levels of development can experience varying degrees of success in renewing their economic prosperity. Not only can this act as a source of hope, but the literature also shows the range of policy options that have been



successfully adopted elsewhere. Although the literature may provide inspiration to regional authorities such as Rostov oblast it nonetheless stresses that success is dependent on the creation of a unique development model embedded in a regions own culture and industrial development. In other words there is no such thing as an ideal 'off-the-shelf' package or 'blueprint' of foolproof policies. Rather success depends on using the experiences of others as a guide and re-designing any adopted policies to suit the circumstances they are being applied to.

It is with the entrepreneurship literature that criticism about reliance on western literature, to analyse an economic environment that has developed differently, could be seen as more pertinent. This is because in the West, where the entrepreneurship models originated, research has been predominantly concerned with discovering who the entrepreneur is. This study is different; it is a meso level enquiry that emphasises context. Although the models of entrepreneurship provide many concepts that can be applied to a meso level enquiry, really it is only the sociological model that examines the social and cultural environments of entrepreneurs. The analysis it produces has provided a more realistic portrayal of small firm formation in less developed regions of the world, which like Russia have not tended to follow the western path of economic development. Its role in the conceptual framework is to help protect against an ethnocentric slant entering the analysis by examining behaviour in terms of societal and cultural influences.

The conceptual framework formed from the three literatures mentioned above were useful for a variety of reasons explained in the previous chapter, but they also had their limitations as noted above. Many of these limitations were overcome by combining these literatures in a selective and creative way to increase confidence in the research results. Each of the literatures complemented each other through the insights they offered as a result of being developed within different academic



disciplines. These literatures though, should not be seen as an eclectic combination of different analytical perspectives. Rather they complement each other to provide a more persuasive and complete study of the phenomenon. In other words they provided related yet different dimensions (through conceptual triangulation) of the same phenomenon under study that when combined contributed to understanding the entirety. The result is a conceptual framework that creates a synergic effect; whereby the analysis from this synthesized conceptual framework has the potential to be more beneficial by showing the complexity and richness of the phenomenon in contrast to an analysis based on just one tradition, which would inevitably be partial.

The first task in creating a conceptual framework is to establish the general categories under which these explanatory concepts will subsequently be placed. All the literatures in the conceptual framework looked at both the economy and society, and two added the polity. More to the point the key concepts themselves divide logically under the headings economy, polity and society, which can be re-categorised as the political environment, the economic environment and the socio-cultural environment. These broad categories are of course not novel in themselves; they are widely used in social science and are useful, and well understood conventional categories under which 'social realities' can be organised and examined for exposition and analysis. The division here is into three familiar broad categories, under which the precise concepts derived from the literatures can be situated and subsequently deployed. At the same time they also communicate something about the nature of the concept and its place in the framework.

Having formulated the framework containing the broad analytical categories (of the political environment, economic environment and socio-cultural environment) it was then necessary to re-position the concepts (from the three literatures) under them in a selective way. Concepts from the IE literature tend to be subdivided into all



three categories. Generally those that are connected with formal institutions which are regulatory in nature are positioned under the political environment (for example property rights, law and enforcement). These formal institutions influence the level of transaction costs, which because it is a cost borne by economic actors and is likely to influence their behaviour, appears under the economic environment. The informal institutions, including the concept of trust, are cultural and describe social behaviour so are organised under the socio-cultural environment. Concepts from the RED and entrepreneurship literatures appear together mostly under the economic environment, though concepts from the sociological model of entrepreneurship which looks at what is affecting the supply of entrepreneurs are organised under the socio-cultural environment. All the concepts have been placed under the environment that best describes their essential character, with those that are closely related collated together. Some concepts though cut across the broad categories, indicating there is an element of simplification implicit in this re-organisation. Categorising the concepts under the three environments facilitates the analytical narrative by the way it orders the material and creates clarity in the substantive chapters four, five and six.

The next task is to order the concepts or variables from the literature under these basic categories. This is shown in figure 3.1 Categorisation of the Concepts. Two concepts from the literature are missing from this categorisation, these are *path dependency* (which is taken to mean evolution over time) and the *rootedness of factors* (or the use of space) within a specific geographic location. This is because together these two concepts provide the temporal and spatial dimensions within which all the variables from the conceptual framework are embedded. These two concepts are included in the diagrammatic representation of the conceptual framework (see figure 3.2 The Conceptual Framework). The concepts included under 'political environment' are connected to the actions and influence of the state; they include ideology which defines the form of the economic system, the specific



actions of national or regional governments via policies, regulations or laws that act as (dis)incentives to economic activity such as small firm formation. The concepts included under ‘economic environment’ bring together several factors including industrial structure and the availability of the factors of production as well as levels of income and demand. The economic factors have a key role in shaping the demand in an economy, which leads to small firm formation, as well as the key notion of

Figure 3.1 Categorisation of the Concepts	
POLITICAL ENVIRONMENT	National state ideology - an enabling or restrictive influence on independent economic activity such as SMEs? Regional/local state –degree of autonomy. State policies towards industry and SMEs. Regulations/laws/property rights on business activity (clear and robust?). Enforcement and judicial system – fair and effective?
ECONOMIC ENVIRONMENT	Regional factors of production, infrastructure (endowment/quality) to support industry/business. Regional industrial structure – size, type of industry, opportunities for small sale activity. Market demand – level and structure, role of income. Economic risks – financial, level of information. Regional economy – general (in)stability. Competition – foreign/indigenous/local/national. Organisations – institutional thick environment. Agglomeration economies and whether these are present. Opportunities for co-operation between firms. Untraded interdependencies. Transaction costs – nature and level as experienced by small firms at start up and in operation.
SOCIO-CULTURAL ENVIRONMENT	Informal rules/regulations/institutions. Social groupings as sources of entrepreneurship. Legitimacy of entrepreneurship. Culture/learned habits – trust, beliefs, morals. Social risk – social climbing/falling as a result of business activity. Corruption, criminal gangs and influence on business behaviour.

transaction costs, which governs the effectiveness of inter-firm (and indeed all market based) transactions. The concepts included under ‘socio-cultural environment’ are all those factors or variables that are derived from the socio-cultural system. They largely influence the supply of entrepreneurship by encouraging or constraining this activity, as well as influencing whether it is undertaken in the formal or informal economy. Trust is an important concept that has been placed under this category,



principally because it is so strongly connected to civil society and is a learned habit, but it also has a significant influence on how the polity and economy operates.

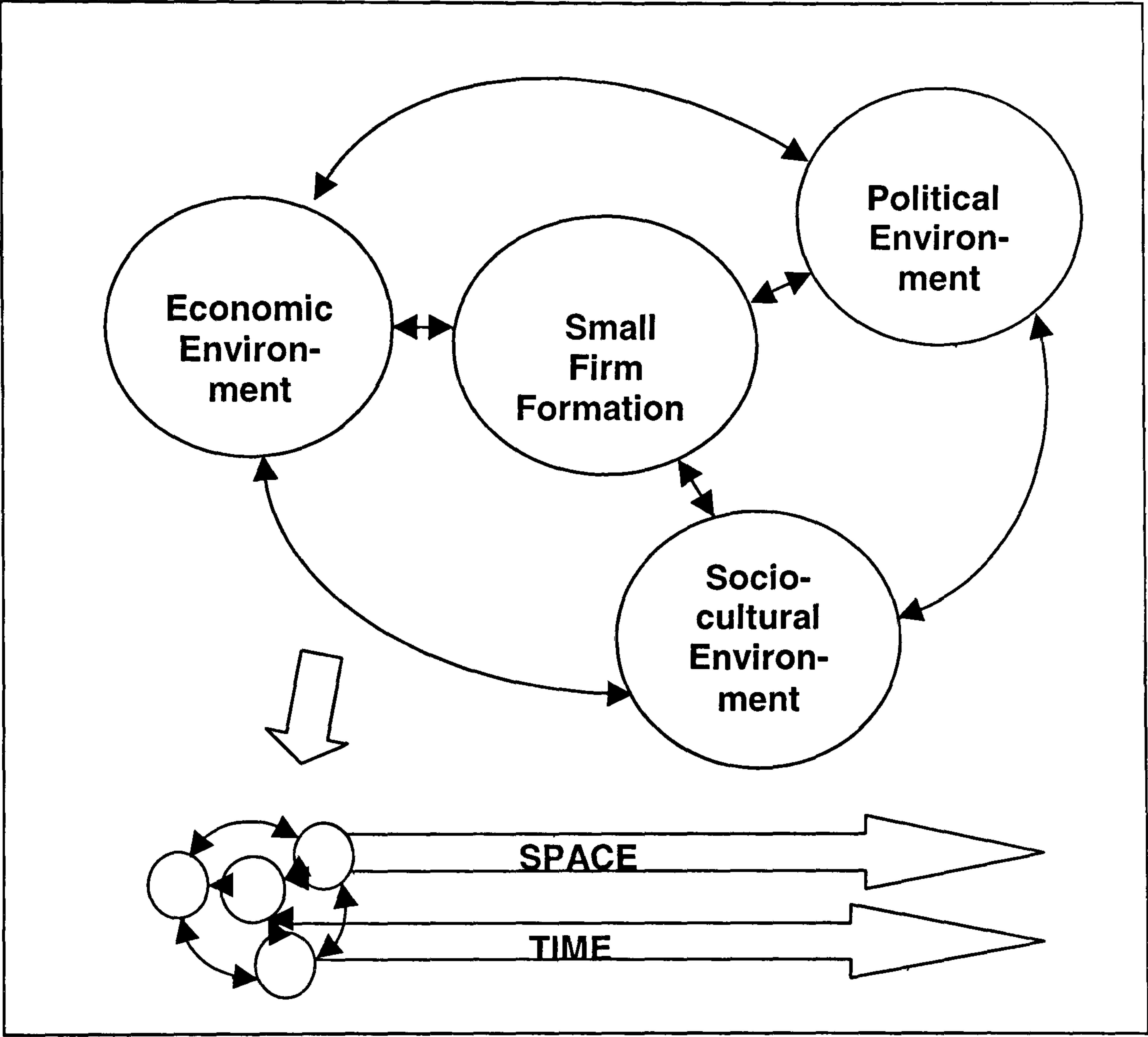
Having sorted the concepts into basic categories it is now necessary to create the framework itself in a form that will be used to structure the analysis of new firm formation in the subsequent chapters. One feature missing from the basic categories is the economic activity under investigation – small firm formation. In addition figure 3.1 tends to give the impression that the categories can be ordered into a hierarchy. The literature review in chapter two however, emphasised that the economy, society and polity *mutually influence* each other and that *together* they shape the type of economic activity that takes place (including small firm formation and the nature of small firm activity). Therefore the conceptual framework has to emphasise the equal importance of each of the basic categories. Another factor that has to be taken into account is that society, polity and economy all *change over time* and space. Space here indicates that there are differences in economic activity amongst regions within nation states and this has as much to do with the regional differences in political and social conditions as it has with the way that indigenous resources have been used throughout this region's history. Figure 3.2 is a diagrammatic representation of the conceptual framework accommodating all these considerations.

At the center of the diagram depicting the conceptual framework (figure 3.2) is the economic activity under investigation, small firm formation. The diagram also conveys that small firm formation and activity both influences and is influenced by the economic, political and socio-cultural environments by arrows pointing in both directions. In addition figure 3.2 represents how the political, socio-cultural and economic environments all shape and are shaped by each other with arrows again pointing in both directions. In essence this diagram shows that any



economic activity such as small firm formation is the result of interaction throughout the whole socio-political economic system, moreover this system can be broken

Figure 3.2 The Conceptual Framework



down into key concepts/variables (influences/factors) listed in figure 3.1. To incorporate the influence of time and space on small firm formation, the economic, socio-cultural and political environments an inset of the diagram is shown with arrows for both time and space. The space arrow conveys that there is a difference as space (geography) changes from a local level to a national level to a world level. The time arrow shows that the socio-political economic system evolves over time, but there is no presumption that this is necessarily for the better. Legacies from the past rooted in space shape economic activity in the present and into the future.



The study that follows demonstrates the theoretical assumption that the polity, economy and society mutually influence the type of economic activity studied. The polity through its ideological foundations is important for providing the regulations and opportunity structure within which business operates. Factors in the economy (also influenced by geography and the way space is used) shape not just the kinds of opportunities that are available for economic activities, but also the way they are exploited, by determining transaction costs. The socio-cultural environment influences an individual's inclination or incentive to engage in entrepreneurial activities and participation in the economy. Another important theoretical assumption in this study is that the economy, polity and society evolve over time in a path dependent manner. These broad theoretical assumptions need to be examined, but first it has to be established the best way to collect and find evidence on them. This is summarised in figure 3.3.

Fig 3.3 Linkage of Theoretical Assumptions with Research Methods	
Theoretical Assumption	Research Practice
The political environment creates the rules (institutions), enforcement and policies, which provide the incentives for economic activity such as small firm formation and parameters within which it can take place.	The political environment needs to be divided up into regional and the national in the historical time periods, characterising dominant ideologies and rule systems. A literature review of books, journal and newspaper articles will provide most information. In-depth interviews can be used to provide additional information.
The economic environment creates the opportunities for economic activity such as small firm formation and contains transaction costs, which influence both small firm start-ups as well as inter-firm exchange.	The economic environment needs to be differentiated into the regional or national as well as by time period. Literature about the regional situation will provide significant local information. In-depth interviews will provide additional local information unavailable from newspapers and other sources. Aggregate statistics published at national and local level will also be important sources of information.
The socio-cultural environment exerts a level of influence on an individuals entrepreneurial behaviour. Cultural actions are learned habits, which change gradually influenced also by the level of trust between key economic actors.	The socio-cultural environment can be examined through a literature review into social groupings, attitudinal change to capitalism, independent economic activity. Trust is an important variable; it is a learned habit, is exhibited in many ways and may be inferred from the literature on the role of the state, role of the informal economy, role of corruption, criminal structures in business and inter-firm co-operation. A survey of the literature published in the region will provide evidence of this, so too will in-depth interviews.
The socio-political economic system changes gradually over time in a path dependent manner. The manner in which it changes is also influenced by the way space is used in the region under study, which may be locally distinctive.	Historical evidence is needed about how the region has changed in the socio-political economy. This information can predominantly be obtained from secondary sources of literature and aggregate statistics, which will be structured into historical periods. A study of a region and the combining of different research methods suggest the need for a case study approach.



Figure 3.3 shows that operationalisation of the concepts/variables has indicated that the study needs to combine secondary data from academic and non-academic sources of literature and official statistics with primary data obtained from interviews. The variables included under the economic and political categories are well-established concepts with readily understood meanings that are clear in the literature and tend to be used consistently. It is the variables under the socio-cultural environment that are more difficult to operationalise and this work is dependent on both recognising them and evaluating their significance. Consequently their operationalisation has been influenced by the literature discussing them. One of the most problematic concepts for this study has been the variable trust. Fukuyama (1995) has defined trust as a learned habit, which is best understood by observing the actions of individuals and businesses. In a low trust society the evidence looked for includes:- the degree of centralisation by the state; the power of the state bureaucracy (and concomitant evidence of corruption), the lack of bottom-up organisations such as religious and charitable groups (with the exception of strong illegal criminal groupings); low levels of co-operation between economic actors and in-house development of services and production that could be bought on the market (Fukuyama, 1995). Having determined what to look for, much of the evidence on trust can be obtained from secondary literature (though this is limited) and will be supplemented by interview data where appropriate.

This study illustrates the use of the conceptual framework in examining a particular phenomenon in its real life context and moreover does this by using a variety of sources of evidence. The need to use different methods meant that a case study approach was appropriate. The case in this context is small firm formation in a specific manufacturing sector within a region of Russia. The next task was to choose a region in Russia in which to undertake the case study and a sector on which to focus.



### **3.3 Establishing the Region and Economic Sector in Russia**

There has been a lot of research undertaken on small firm formation in transitional economies, for example Smallbone et al, 1996; Brezinski et al, 1996a; Malle, 1996; Acs et al 1993; Alimova et al, 1995. Consequently it was well known that small firms were developing well in the tertiary sector during the early transition years. This was because the tertiary sector was underdeveloped in socialist planned economies, so small firm development in this sector was a sign that this deficiency in the economy was reducing. The development of small business in the tertiary sector alone however, would not improve Russia's economic efficiency. What was needed was small business to develop in the manufacturing sector.

Early research conducted in transitional economies both in Eastern Europe and Russia indicated that small business was beginning to form in some manufacturing sectors (Smallbone et al 1996, Smallbone, 1999). One of the manufacturing sectors where small firms were forming was in food-processing. There are two possible reasons why this may have happened. Firstly, food is one item of consumer expenditure that remains a necessity even during times of economic hardship. Thus unlike products from other sectors there is likely to be a certain degree of market demand for food products no matter how difficult the economic situation. Secondly, investment in equipment and raw materials needed for some food-processing production such as baking is likely to be less of a financial burden than for example investment in machinery to produce bicycles, cars and other consumer durables. This meant that food-processing, with many of its sub-sectors having low entry barriers, was considered one manufacturing sector that could experience new small firm formations fairly early on in the transition process. Consequently an in-depth study of this sector could contribute to an improved



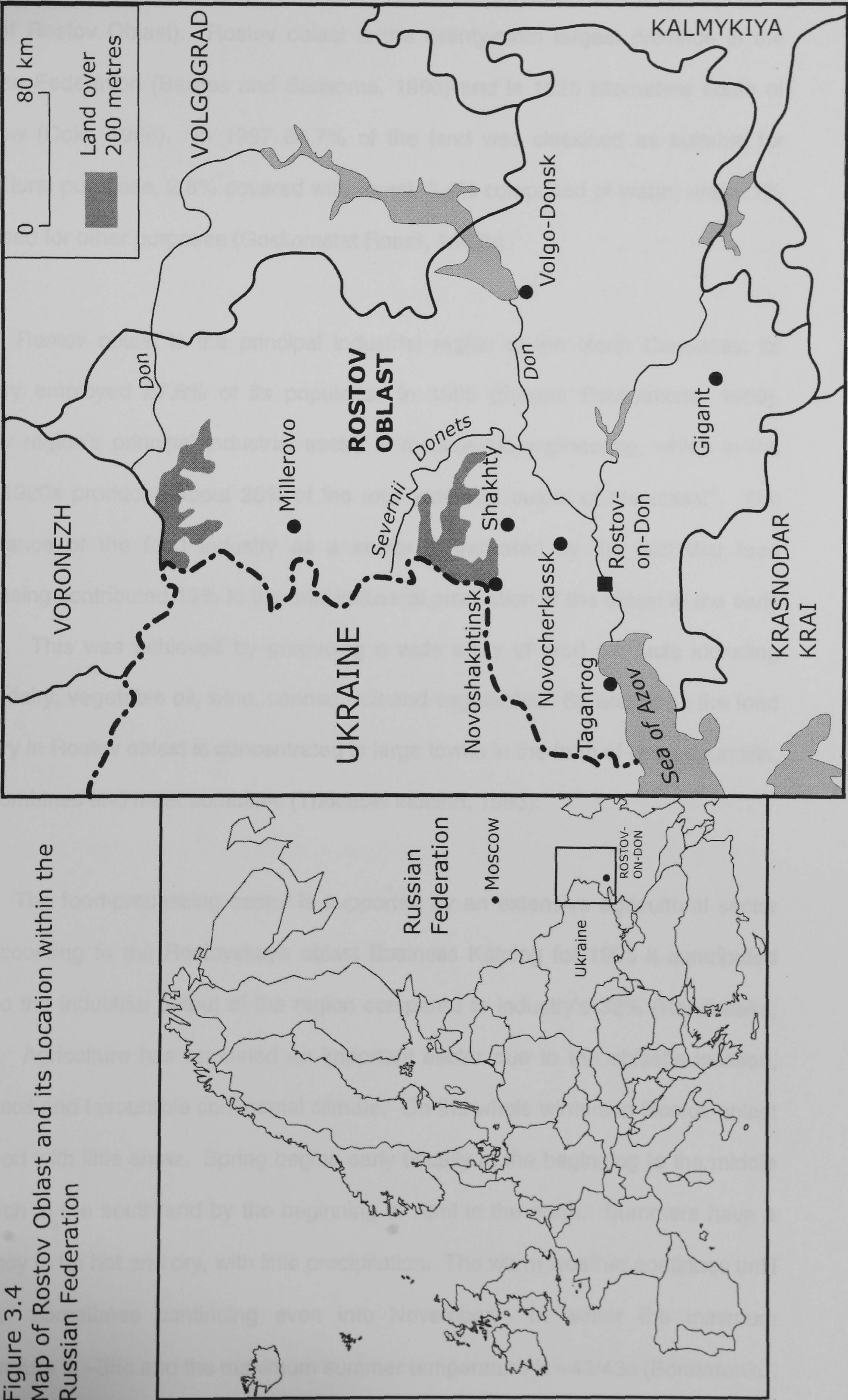
understanding of the various influences on small firm formations in the transition period.

With food-processing as the sector under investigation it was necessary to find a region that had a comparative advantage in agriculture that was capable of supporting new small firm formations in food-processing. A region with a strong agricultural sector should ease access to raw materials for small processing firms and also provide sufficient scope for the new small peasant agricultural producers to move into processing. The North Caucasus (since May 2000 the Southern Federal District) economic zone<sup>1</sup> has some of the most fertile agricultural land (known as the black earth) within the Russian Federation. Moreover, it is not totally reliant on just agriculture; it also sustains a variety of industrial branches. This provided yet another important factor, because a sizeable urban population might have sufficient income to afford products produced by the local food-processing sector.

The choice of region, having been narrowed down to the North Caucasus Economic Region, centred on Rostov oblast. Rostov oblast was chosen because it is an important industrial and agricultural region in the North Caucasus. It was formed on the 13 September 1937 on the area that was formerly called the oblast of the Donskogo voiska during the Tsarist period<sup>2</sup>. It lies in the south of the Eastern European plain on the Don River Basin in the south-west region of the Russian Federation (Cole, 1968). It is 104,900 kilometres square<sup>3</sup> (Bondarenko, 1969) and occupies one fifth of the territory of the North Caucasus (Brovkovich, 1963). It stretches 470 kilometres from north to south and 455 kilometres from east to west. Its border in the west is with the Ukraine, in the north with Voronezh; in the north-east and east is Volgograd, in the east and south-east are Kalmykiya and Stavropol and to the south and south-west Krasnodar krai (Bondarenko, 1969) (see figure 3.4 The



Figure 3.4  
Map of Rostov Oblast and its Location within the  
Russian Federation





Map of Rostov Oblast). Rostov oblast is the twenty-ninth largest province in the Russian Federation (Barnes and Sansome, 1996) and is 1226 kilometers south of Moscow (Cole, 1968). In 1997 84.7% of the land was classified as suitable for agricultural purposes, 2.8% covered with forest, 3.4% comprised of water, and 9.1% was used for other purposes (Goskomstat Rossii, 1997b).

Rostov oblast is the principal industrial region of the North Caucasus; its industry employed 27.8% of its population in 1995 (Europa Publications, 1999). Rostov region's principal industrial sector is mechanical engineering, which in the early 1990s produced about 28% of the total industrial output of the oblast<sup>4</sup>. The importance of the food industry as a sector is indicated by the fact that food processing contributed 19% to the total industrial production of the oblast in the early 1990s. This was achieved by producing a wide array of food products including meat, dairy, vegetable oil, wine, canned fruit and vegetables. By and large the food industry in Rostov oblast is concentrated in large towns in the form of large flourmills, milk combines and meat combines (Traktebel industri, 1993).

The food-processing sector is supported by an extensive agricultural sector and according to the Rostovskaya oblast Business Katalog for 1996 it contributed 35% to the industrial output of the region compared to industry's 32% (Handshake, 1996). Agriculture has remained an important sector due to the oblast's location, fertile soil and favourable continental climate. On the whole winters in Rostov oblast are short with little snow. Spring begins early usually at the beginning to the middle of March in the south and by the beginning of April in the north. Summers have a tendency to be hot and dry, with little precipitation. The warm weather continues until October sometimes continuing even into November. In winter the minimum temperature is -35c and the maximum summer temperature is +42/43c (Bondarenko, 1969) making it better suited than many other regions in Russia for agriculture.



The total area used by agriculture is 6 million hectares and the fertile black earth covers 64% of the oblast (Barnes and Sansome, 1996). This land was farmed by 16.5% of the working population working in agriculture in 1995 (Europa Publications, 1999). The main agricultural products produced on this land are grain, corn, winter wheat, barley, flax maize, sugar beet, vines, sunflower seeds, fodder crops, and livestock (mostly cattle, pigs and poultry, and some sheep mainly for their wool) (Traktebel industri, 1993). Fruit (including grapes and melons) and vegetables are both cultivated there (Hooson, 1966; Solovova, 2000). Animal husbandry despite its expansion during the Soviet period is still of secondary importance to arable farming which produced on average in the early 1990s 8 to 9 million tones of grain per year (Barnes and Sansome, 1996).

Despite covering a small area of the North Caucasus, Rostov oblast is the most heavily populated region<sup>5</sup> within it with 43.94 people per square kilometre (Barnes and Sansome, 1996). Moreover not only did its total population number 4,420,000 on the 1 January 1997, in 1996 it was the sixth most populated oblast in the Russian Federation. It also has a large urban population, in 1996 for example the urban population made up 67.9% of the total population or approximately 3,004,575, whilst the rural population came to 32.1% or 1,420,425 (Europa Publications, 1999). The capital of Rostov oblast, Rostov-on-Don<sup>6</sup> is the only city in the North Caucasus with over a million inhabitants. On the 1 January 1997 its total population was 1,022,900 (Goskomstat Rossii, 1997b). Out of the 23 cities in Rostov oblast the most important apart from Rostov-on-Don are: Taganrog with a population of 291,600 in 1996, Novocherkassk, with a population of 189,000, Shakhty with a population of 229,200, Novochaktinsk with a population of 105,700 and Volgo Donsk with a population of 182,100 (Europa Publications, 1999). Rostov oblast itself is divided up into 43 administrative districts known in Russian as *raioni* (Goskomstat Rossii, 1997b).



In the 1990s Rostov oblast remained an important agricultural region within the Russian Federation and one that was important for the food-processing industry, which tended to be organised on a large-scale in most sectors. There was consequently a distinct possibility that small food-processing firms would be able to source their agricultural inputs from within the region. Another advantage was that Rostov oblast had a population, which was employed in a diverse range of industrial sectors. This meant that there was a strong likelihood that although some sectors in Rostov oblast would have suffered as a result of transition and contributed to unemployment levels, there would have been other industrial sectors that would have been less seriously affected. So it was surmised that demand and consumption may have remained more stable in Rostov region than in other less industrially diversified economic regions creating some favourable opportunities for new firm formation. If the advantages of location proved insufficient by themselves to encourage small firm formation in the processing sector, then the analytical explanation will need to consider other economic factors in the conceptual framework.

### **3.4 Methods for Data Collection**

The choice of research methodology for this study was informed by the nature of the research questions and the conceptual framework. Another important factor that had to be taken into account when deciding on the research methods that would be used was the time constraint placed on field work and the anticipated difficulties that would be encountered when undertaking research in another culture. As noted in figure 3.3 (entitled The Linkage of Theoretical Assumptions with Research Methods) the research methods that were suggested by the theoretical assumptions were predominantly secondary literature and aggregate statistics with some interviews. As this research was to be conducted at the regional level, focussing on one industry



and using these multiple research methods, it broadly followed a case study approach.

### 3.4.1 Assessing the Research Methods and Data Collection

The following section is an assessment of the research methods used in this project. These include secondary literature and statistics (in the form of academic books, journals, newspaper articles, internet articles and official aggregate statistics in both English and Russian language) and in-depth interviews. These different methods were combined together to create a *case study* of a region and its small firm formation activity over three historical periods to illustrate the application of the conceptual framework.

#### 3.4.1.1 Case Study Approach

This project has broadly used a case study approach to understand what was affecting small firm formation in one region and one sector over different historical periods. The case study approach was chosen not to examine a traditional case, but to obtain sufficient data on a wide range of variables to illustrate the application of the conceptual framework. The different variables and the combination of an historical analysis with a contemporary investigation required a certain flexibility in the research methods used for data collection. This was because the conceptual framework and the research questions had already indicated that secondary data in the form of literature – newspapers, academic books, articles in English and Russian would be important, as would official aggregate statistics and some interviews. Both the historical and more contemporary information used similar sources of published literature and official statistics; however, the more contemporary information was



supplemented with some key informant interviews. In addition the shortness of the field trip and anticipated difficulties in obtaining interviews in Russia required flexibility over the use of research methods. All of these considerations meant that a case study approach would facilitate obtaining sufficient data to gain in-depth knowledge about the particular case of the food-processing sector in Rostov oblast within its specific historical and contemporary political, economic and socio-cultural environmental contexts (Newman, 1994; Hamel et al, 1993).

Unlike collecting statistics and literature, interviewing in the field proved to be the most difficult form of data collection because not only were individuals reluctant to be interviewed, but it took time to identify and arrange meetings with informants. This problem was exaggerated by two factors. Firstly this researcher found that the Russians that were contacted tended to be reluctant to talk about their business activities. This could have been for a variety of reasons not least because the researcher was unknown to them. Moreover it could simply be demonstrating a broader lack of trust within Russian society; for example even reassurances that all data would be confidential and only used for academic purposes failed to convince some potential interviewees to take part. Those who were interviewed were often reluctant to provide some information; one notable example of this was the refusal to state occupation during the Soviet period. Other questions elicited the response that the interviewer was a 'spy' even though the paperwork, they were presented with, verified that this was an academic research project.

The second reason for encountering difficulties in organising interviews occurred because the main research trip took place at the same time as the devaluation of the rouble. This meant small business owners were unavailable for interview because they were dealing with this financial issue. Even without devaluation obtaining interviews would not have been easy, but the rouble crisis only



further complicated making such arrangements. Consequently research in the field became even more dependent on other data collection methods. The case study approach then proved to be vital for this research as it accommodated the need to make greater use of secondary data and was flexible enough to incorporate some primary data where appropriate.

A case may be an organisation, a person, country, department and so on, and is usually bounded either by an activity or space (Creswell, 1994) and sometimes by time. In this instance the activity under investigation was small firm formation in the food-processing industry and the geographical space was Rostov oblast, but the time frame was broad. One sector of industry was chosen to add depth to the research that had already been undertaken on small firm formation within a variety of sectors in transitional economies. Concentrating on one region was important for the following reasons. The literature on regional economic development had highlighted the issue that regions differ not just with regards to locational or natural resource advantages but also due to their inherent and inherited societal processes culture and traditions. Understanding these influences requires time and a thorough investigation of historical secondary data. Time constraints meant that two regions for comparison would have been impractical. Moreover as the study is based on the use of a conceptual framework that may be applied to any region on its own a comparative element was not necessary. The Rostov oblast study then became a way of illustrating the value of the conceptual framework through the insights that it generated.

The advantage of using different evidence based methods of collecting data was that it allowed for triangulation. Triangulation facilitates the collection of different dimensions of the same data to produce a complementary yet related and hence more complete analytical description or contextual portrayal of small firm formation in



food-processing. This completeness enhances the validity of the research; moreover the data collected by different methods when similar not only verifies itself but is understood as being more reliable. The danger here is that errors may be reinforced, though this study minimised this by the methods it used. So although this study relied heavily on secondary data, much of it was produced in Russia and in Rostov region, this improved its reliability because it was written from a Russian perspective. Moreover interview data was always checked against secondary data to increase validity and reduce researcher bias. Although no observation or interpretation can be perfectly replicated, triangulation goes some way to doing this, because by producing consistent results the credibility of the research findings increases (Stake, 1994).

#### 3.4.1.2 Official Statistics and Other Secondary Data

One important source of data for this project has been aggregate statistics collected both on a national and regional level and from different historical periods. There are problems with using statistical data compiled in Russia irrespective of when it was collected. This is because there have been changes in how statistics are collected and in definitions. In this study it was difficult finding consistent statistical data on small firms, because the definition of what constituted a small firm changed not just in the 1990s<sup>7</sup> but also during the Tsarist period. Sometimes statistics have been manipulated in other ways so that they provide less complete information than they initially appear to. Just as in the Soviet period it was not unusual for statistics to have been inflated for political reasons, in the post-Soviet period of the 1990s statistics may have under-represented reality as information was concealed from the authorities.

As for statistics on small firms in the early post-Soviet period they tended to be collected on the numbers of employees rather than other factors such as turnover



or profits, simply because levels of inflation tended to make these indicators less useful (Chepurenko and Vilensky, 1996). Even so small firm statistics were still likely to underestimate the total numbers of small businesses in existence. This was because they not only ignored those small firms operating in the informal economy, but also because there was no indication in the statistics as to whether the small firm was entirely new, active, in-active, a subdivision of a former state-owned firm or a Soviet co-operative. (EBRD, 1995). Consequently statistics remained rough and somewhat unreliable in Russia (Bruno, 1997). Despite these problems they were the only source of statistical information available. Consequently they were used in most research articles on small business to provide a general estimation or trend in the numbers of small firms being formed; they did not change for the period or times they represented and hence were the most valid statistics that existed. As Russian small firm statistics lack internal reliability they will not be used in this study to compare the level of small firm formation in the 1990s with the Soviet and more distant past. Moreover even though they are not very reliable they are still useful for understanding the extent to which small firms were developing during the early transition process.

Other forms of secondary data were collected from a variety of sources. The materials came from the internet (notably articles by academics, Russian organisations such as the Russian Ministry of Agriculture and international organisations such as the OECD) from Russian and English academic books and periodicals as well as analysts reports and newspaper articles. Russian newspaper articles were mostly from local regional publications such as Gorod N, Molot and Rostov oblast's version of Argumenty i Fakty. The specific sources are cited as appropriate in the empirical chapters. The result is the formation of a fairly comprehensive account of the development of the food-processing industry within the region, both over a long historical time frame and during the 1990s. Even if these



articles or books have not concentrated on the food-processing industry they have referred to it, adding to an understanding of it and its role in the agro-food system.

One important aspect of using the secondary data has been interpreting the 'spin' put on the information by organisations collecting it. One example of this was the particularly negative literature written in Rostov region during the Soviet period on the development of the food-processing industry during the Tsarist period. Here it was essential to understand that ideology had governed the way historians in the Soviet period had interpreted information on the Tsarist past. For information published in the 1990s this may appear to be less of a problem, however, it must be remembered that some international organisations interpret information to suit their own internal agendas. The only way round this problem is to relate the information to a variety of different sources available and interpret by relating it to the Russian context. There are though also issues connected with using the internet which do not apply to other sources of secondary data. In many instances, articles found on the internet were not dated, nor were details about research visits and methods made clear. Consequently, care has to be taken when using this information; other sources remain useful as a way of trying to date or validate it. Furthermore, unlike other academic articles, some information on the internet had not been peer reviewed. Again care had to be taken when using it, moreover comparing it to other sources of data ensured that accuracy and reliability was maintained.

The advantage of using official statistics and secondary data is that they are seen as more authoritative, having been compiled by either the state or reliable research institutes. Moreover, secondary data is very comprehensive and has a long time span providing this study with an historical appreciation of the problem. So secondary data was important for facilitating the collection of a large amount of data in a short period of time, which was then used in some places to confirm any primary



data (collected from interviews) with the result that the credibility of the research was protected. Statistics and other forms of secondary data not only improve credibility they can also help to formulate hypotheses, which can be verified and tested by other means. Another advantage of using them is that the researcher has little influence on their collection. As a result the interviewer effect is minimised which strengthens the validity of this data.

There is however, a danger that the material may have been manipulated by the provider/publisher. As noted above bias and propaganda can influence the way material is presented; but as long as this potential problem is recognised and is compensated for then this is less likely to be such a serious issue. The secondary data and academic literature that has been officially published appear to be of reliable and valid sources, albeit written with a degree of subjectivity. Moreover, some of the literature was not written to discuss the food-processing industry but for the fulfillment of other aims, which could indicate its unsuitability. But even this can be used in conjunction with for example research published in the West to provide extra detail of what happened to the food industry in the past and in the 1990s. The internal validity of other forms of secondary data (other than statistics) could be questioned because of a lack of detail about the methods used to collect it, nor is there any mention of possible areas of bias that may have occurred in its collection. The only defence against this is that the wide sources of secondary data used in this study, including some published in a variety of oblasts (regions or provinces), as well as Rostov help to validate the material employed.

#### 3.4.1.3 Semi Structured Interviews: a Source of Primary Data

Semi structured interviews were conducted with several informants including small bakery owners, representatives from regional support agencies and food industry



organisations as well as ministry officials (see appendix 1). This data is incorporated into chapter 6 and more fully explained there. These interviews provided good opportunities to confirm data obtained from the literature and to explore important issues. The time of the research visit followed the currency crisis of August 1998, and was a particularly awkward time to obtain interviews by Russian researchers let alone foreign researchers. It seems that interviewees in general were less trustful during this period of instability in the economy. As a result of a lack of trust interviews were not taped. This might appear to lower the reliability of the interviews, but it was the only practical option. The credibility and reliability of the interviews was increased by the hiring of a translator who took notes, as did the author of this study. Following each interview there was a detailed discussion of the notes, and issues that were raised during the interview were clarified. The translator helped to improve the validity of the data obtained during interviews when there were problems with lack of vocabulary, or when it was difficult to formulate questions. Each interview was also translated and written up following this discussion.

Another factor that might have lowered the stability/reliability of the interviews was that a second visit was not feasible, even when it might have been desirable. Just obtaining one interview took a long time, and it would seem at least that some interviewees (especially small business owners) were too busy to co-operate with academic researchers. Moreover, even if a second visit had been possible, the nature of a semi-structured interview does not allow for a full replication of the situation. Firstly this is as a result of the relationship between the interviewer and interviewee altering between visits. Secondly the atmosphere may not be fully replicated; as both the interviewee's and or interviewer's frame of mind may differ, influenced by a variety of factors for example personal or professional factors that the interviewer might not be fully conscious of. Finally, the questions asked depend on



the information that is obtained during the interview, and there is no guarantee that despite starting with similar questions the conversation will lead in a similar direction.

The advantage of semi-structured interviews is that they allow for the probing of more information, they also allow for a clarification of any unclear terms. As a result they provide some qualitative insight into what is occurring in the new firm sector and this differs to information from secondary sources. Interviews deepen understanding through anecdotal evidence and individual stories, even if they were not sufficient for quantitative analysis. The main disadvantage, and one that was evident during the three months field research, was the significant time that was spent in arranging interviews that sometimes fell through at the last minute. Another issue with interviews was the power relationship between the interviewees, (all middle aged men who had lived through the Soviet period in what was essentially a patriarchal society) and the interviewer, a female student from a western developed nation with less knowledge about the Russian food industry. To minimise this power effect interviews were conducted on a professional basis around a check-list of questions with a degree of formality. To improve the validity and reliability of the data obtained from interviews it was then compared to the literature that had been published on the food industry in the local press, research articles and books.

This study does not claim that the research findings will be entirely transferable (externally valid) to any other regions outside the study region (within the Russian Federation) because the processes that affect the regional polity, society and economy are place bound. The results however, will nonetheless provide a valid picture of the food-processing industry within one region of the Russian Federation that would be recognisable to others with some knowledge of this industry. As a result this study should provide a credible description of what has affected small firm formation in the food industry throughout its recent and more distant past. This



description, however, might not be indicative of any trends occurring throughout all of Russia, although there should be some commonality with other regions. Furthermore the theoretical framework that has been used will be useful to other researchers in other regions and will be transferable as a research tool.

### **3.5 Field Work and Methods in Russia**

There were two field trips to Russia, the first occurred from February to March 1998, and the second took place from September to December 1998. The first trip was primarily to establish contacts in the field who could help and to determine the kinds of difficulties that could influence the way that the research would be conducted. For the first trip two research areas were identified. The first was Nizhny Novgorod, and the second Rostov-on-Don.

The first field trip was illuminating for a variety of reasons. Firstly it was decided not to adopt Nizhegorodskaya oblast as the region of study. Nizhny was originally chosen as an ideal site because it was a region, which was well known to be progressive and, apart from the capitals of Moscow and St. Petersburg, also had a substantial number of small firms. It was, however, not a particularly agricultural area. Another factor, that proved to be disadvantageous for Nizhny as the research site, was the dominance of western support agencies already operating in this region. It was felt that depending on these agencies for contacts might influence the data recovered from interviews. Reliance on agencies for contacts with small firms had the potential to put pressure on small firm owners to provide a picture of the situation facing them as similar to the one painted by the agencies. In addition there was potential for small firm owners to consider that any data (despite assurances of confidentiality) may leak to the support agencies, especially if it did not correspond with the support agencies beliefs. As a consequence, it was felt that there could be



the potential for some bias to enter into the data collected in this region. In Rostovskaya oblast (Rostov oblast) there were fewer international agencies to make contact with. Here most contact was with Russians at indigenous research institutes, though there were also contacts with a few international organisations. This was advantageous because it meant there was less restriction on discussing general ideas from the data received (if it were not confidential) with any of the contacts. The result was that the data obtained described more accurately the conditions that existed. It was at this stage of the research design process that a combination of interview data with secondary literature research was identified as being appropriate to fulfil the aims of this study.

In the second field trip interviews and library research were conducted. Both of these activities were confined by practical circumstances and working practices in Russia. Interviews were arranged with the informant, sometimes directly by the researcher, but mostly through contacts. There were two contacts that were able to arrange the majority of the interviews. One contact was a Russian academic, who was a former Tacis consultant with specialist knowledge on the food industry. The other contact was a Russian businessman who was running a small investment company. These individuals offered as much help as they could in the circumstances without harming their own interests.

Many representatives of companies or organisations were reluctant to be interviewed, and there were justifiable reasons for this. Many owners of companies were unwilling to lose valuable time talking to a researcher who would offer no direct benefit to them or their company. The currency crisis may have influenced this by contributing to increased distrust. This happened particularly on one occasion, with an acquaintance of the translator, who ran a small bakery. This baker declined to be interviewed, despite firm assurances that the conversation would remain confidential.



Indirectly this refusal contributed to an understanding of how the lack of trust in the business community contributes to restricting economic activity. Arranging interviews without a contact was more difficult for a number of reasons, but it was still possible.

Often the contact such as the Russian academic was able to use their influence with official bodies to gain access. As for small companies, even locating them was difficult. Telephone books did exist, but in general they were not up-to-date. Furthermore many small firms were unlikely to be listed in them. Cost may have been important in not being included in directories but also published information had the potential to attract undesired attention (specifically from criminal organisations). Finding small firms in towns was also not easy, for small firms did not always place signs or fascias on the front of buildings. In addition small firms often used buildings, which from the outside did not look appropriate, or were located in what initially appeared obscure areas.

Although the conceptual framework created for this study used interviews, it did not have to rely upon them as the predominant source of data generation. So as arranging interviews was time consuming, and there was limited time in the field, it was often more productive to spend time in local libraries examining newspapers, books and articles about the contemporary and historical circumstances in the food-processing industry. In Rostov several libraries were used for this research:- the library at the Rostov State Economic Academy, the library at The Institute of Management, Business and Law, the library at The Russian Academy of Agricultural Science (a research institute, which previously researched planning for the food industry), and the main public library (Donskaya publichnaya biblioteka). All three libraries had different publications and all were important. The relatively new Institute of Management, Business and Law had the least number of books in its collection, though it was useful in terms of its up-to-date books and articles on the business



history of Russia. The Rostov State Economic Academy had many publications by researchers from its own institute, and thus was an important source of information on the contemporary food industry and small business. The Russian Academy of Agricultural Science, that previously researched planning for the food industry, had fewer recent publications but had an interesting collection of books and articles on the history of the whole food industry in Russia in general as well as relating more specifically to Rostov oblast. Researchers within this academy made their own papers available, especially those exploring what had been happening to the food industry including food-processing since 1991 both in Rostov itself, as well as in other regions within the North Caucasus area. The public library had a fairly large collection of published books on the history of the food industry, and food-processing in particular from the Tsarist period right through to the Soviet period. It had less information about what was happening to the food industry as a result of the transformation process. Although it did provide access to many local newspapers, which provided some useful information.

Libraries within Russia differ significantly to libraries in the UK, and it is worth highlighting some of the practical difficulties of library based research in Russia. For example at the time of this research there were no computer catalogues only card index catalogues. Users of the library were not able to browse the open shelves but had to fill-in in triplicate order forms, which were then handed to librarians who would then fetch the materials. There were some complications with this system. It was time consuming to fill in the forms and queue to place and pick up an order. Generally this process took about an hour or even longer at certain times of the day, although time could be saved by ordering books or articles the previous day. Additional problems included:- judging the appropriateness of the material from the title in the catalogue, ensuring that the shelf numbers written on the order forms were



in an appropriate Russian style and books being unavailable because they had been stolen or lost.

Having received the material, the next stage was to make notes or photocopy it. Making notes was the easier option either in the form of a quick rough translation or by copying out important passages in Russian. Dictionaries taken into the library had to be signed for and on leaving all documentation was checked again; to avoid this onerous bureaucracy the dictionary was eventually abandoned. It was also possible to have materials photocopied, but again this was a bureaucratic process involving queuing and limiting the pages to be photocopied to no more than ten. The poor quality of the photocopies from the library meant that this system was of limited use.

One way around the library system was discovered about half way through the second field research trip. In a general conversation about the difficulties of using the public library with the librarian at the Academy of Agricultural Science, it was discovered that this academy had a connection with the public library, and this meant that the librarian could order materials to take out. The librarian visited the public library once a week for this purpose. Consequently it was then possible to increase the amount of materials that could be obtained and also use more efficient photocopying facilities that were available in nearby local bookshops.

Current statistics were also obtained from The Russian Academy of Agricultural Science. It had the most recent statistical publication (dated 1996) covering all aspects of industry and services for Rostov oblast. It had some information on the size of the region, population statistics and statistics on industry and agriculture. This precious publication, of which there was only one copy, had to be used on the premises, no photocopier meant that statistics were copied out by



hand into a notebook. This institute was still waiting for the updated 1997 version, but the cost of printing and paper meant that this statistical publication had still not been published by the winter of 1998. Purchasing statistics from the regional statistical office was not as simple as it was in Moscow. There was no bookshop that was open to members of the public. Instead, an individual requesting statistical information had to take a letter written by an official body to the statistical office, where if it were accepted, workers in the statistical office took details of the requirements and matched them up with whichever publication they had. This approach was followed, however, the statistical publications that were available were not entirely relevant, and the payment for a non-national was prohibitively expensive. One important source of statistical information on the food industry was in Moscow from the Agricultural Department at the Institute for Economies of Transition. As a consequence the most relevant statistical information on the food industry was obtained on return to Moscow, at the end of the second field trip. The Institute for the Economy in Transition had the most up-to-date statistical information on all aspects of the food industry. Furthermore, there were no complications in borrowing any publications to photocopy.

The above section has given an overview of the way methods were used in the field and the problems that were encountered. It has also discussed the validity and reliability of the information obtained, and how they were checked to improve the quality of the analysis.

## **3.6 Conclusion**

Drawing on an extensive literature review this chapter has introduced the conceptual framework that the next three chapters will use to analyse the data obtained by the methods outlined above. The framework aspires to be both comprehensive and



rigorous, capable of providing insight into what determines new firm formation and activity in an economy, by careful characterisation of all the relevant contextual circumstances and factors. The framework drove the methodology but difficulties and time restrictions in the field meant that the methodology had to be flexible to ensure the collection of data that would answer the research questions and fulfill the research aims. The research strategy that allowed for sufficient flexibility when choosing appropriate research methods that would provide data to illustrate the conceptual framework was the case study approach. This case study approach allowed for the combining of methods that suited the situation in the field as well as the needs of the conceptual framework. These needs were met by blending secondary literature and statistics as well as some interviews. In practice secondary data collection proved to be the most productive method of data collection in the field. This was supplemented with interview data that was obtained whenever feasible and which added a qualitative dimension and exemplary material. It had been acknowledged, during the design process, that interviewing might not be so simple in Russia and therefore flexibility was incorporated into the research design to reduce pressure on the researcher when in the field collecting data. Time constraints and the time taken in arranging interviews together with a lack of trust and small business owners unable to find time to meet meant that interviews became less important than obtaining sufficient secondary data. The secondary data in the form of published literature, analytical reports and statistics is diverse including Russian sources published in Rostov region itself and other regions, as well as English language sources.

Rostov region was chosen as the case study region principally for its comparative advantage in agriculture, which, it was assumed, would provide opportunities for the formation of small firms in the food-processing sector. Rostov oblast at the time of the research was also industrially diversified, with a large urban



population, this was considered advantageous for it meant there was likely to be a potential substantial pool of consumers. Another important point was that Rostov oblast had historically been a major food producing region and as the literature review suggested, being an indigenous industry it had a greater capacity to survive the withdrawal of state support during the transition period.

The past has shaped the development of the whole food industry including the processing sector in Rostov oblast. The next chapter charts the start of this sector's development and the factors that have shaped it, and in doing so themes will be identified that remained relevant in the 1990s. The ultimate aim of this project is to add to understanding of the way small firms in this sector were forming in the 1990s, in any economy but especially in a transitional economy, which is the subject of chapter six.

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### End Notes

<sup>1</sup> The North Caucasus contains the following oblasts and republics:- Krasnodar krai, Stavropol krai, Adygei Republic, Dagestan Republic, Kabardino-Balkar Republic, Karachaevo-Cherkess Republic, North Osetia, Ingush Republic, Chechen Republic as well as Rostov oblast (Morozovoi, 1995). Although the North Caucasus is now officially known as the Southern Federal District, the same areas are incorporated within it, it is just a name change. Therefore, this study will continue to use the term North Caucasus because it is familiar and widely associated with these provinces.

<sup>2</sup> The area of Donskaya oblast may have been larger than the area known as Rostov oblast, unfortunately the publications used in this research did not specify any differences.

<sup>3</sup> The total area that Rostov oblast covers differs in many publications, in several it is 100,800 square kilometres (Europa Publications, 1999). On the 1/1/97 the territory was 100,9 thousand square kilometres (Goskomstat Rossii, 1997b).

<sup>4</sup> The other important sectors are hydroelectric power, which produces about 9% of total industrial output. The coal industry in the East Donbass coal field contributes significantly to the fuel industry total which also comes to about 9% of industrial output, metallurgy contributes 8% and chemicals 6% (another important industry is the production of building materials). Heavy industry is concentrated in Taganrog and Sulin, the chemical industry is located in Kamensk, Shakhtinsk, Volgodonsk, Novocherkassk and Rostov on Don (Traktebel industri, 1993).

<sup>5</sup> 27% of the total population in the North Caucasus lived in Rostov oblast in 1963 (Brokovich et al, 1963).

<sup>6</sup> The town of Rostov was founded in 1749 and was part of the Ekaterinoslavskaya gubernia until 1887 when it was transferred to the oblast of the Donskogo voiska (Dzyubenko et al, 1979).

<sup>7</sup> The definition of small business in Russia has changed several times through the 1990s just like the ministers and agencies in charge of SME policy (OECD, 1998b).



## Chapter 4

# Small Business Formation in the Food Industry During the Tsarist Period

### Chapter Outline

This is the first of two historical chapters using the conceptual framework to examine the legacies or origins of characteristics affecting small firm formation in the 1990s. Through this chapter it becomes evident that there has never been a lack of an 'entrepreneurial spirit' in Russia or in the Don region; rather independent economic activity has been constrained by the social and economic environments and the institutions that developed. For example this chapter shows how the social structure defined and confined entrepreneurial activity. Other factors that come through as being important are:- the significance of the defence industry and the slow development of the consumer market, low levels of trust that result in a culture of concealment, corruption in the bureaucracy; high taxation and bureaucratic complications for licensing business. Many of these factors in Tsarist Russia combined with others to keep transaction costs high and in doing so shaped the way non-state independent small firms formed and operated.

## 4.1 Introduction

This chapter uses the conceptual framework developed in chapter three to explain the factors and circumstances that have determined the extent and nature of small firm formation in the Don region (re-named Rostov oblast in the 20<sup>th</sup> century)<sup>1</sup> during the Tsarist period. The conceptual framework demands a comprehensive examination of history, and this is the first of two chapters to adopt just such an historical approach for examining the origins of factors that have become evident as determining small firm formation in the 1990s, the subject of chapter six. The next chapter examines the Soviet period and its conclusion establishes not just the nature of historic continuity between the Tsarist and Soviet periods, but also provides pointers as to how this legacy is likely to shape small firm formation during the post-Soviet period.

To analyse the nature and extent of small firms both chapters four and five make extensive use of academic secondary sources of literature in English and



Russian, mostly in the form of books by economists, historians and political scientists. Wherever possible Russian sources that were primarily concerned with the Don region were used. As there was potential for many key Russian sources (written during the Soviet period with a Marxist interpretation) to contain biases promoting the achievements of the Soviet state over the 'imperialistic' Tsarist state, literature by academics writing in English was used to provide a balance. An additional important check on potential bias is to have an awareness of where it could exist whilst using the material. Probably the most challenging aspect of using secondary literature is that having been written to fulfil other aims, it would only be partially relevant to the purpose of this chapter. To overcome this difficulty many different sources were used. Despite these challenges using secondary literature was beneficial. It was relatively cheap to collect and there was a sufficiently large amount of material available, which although not always directly applicable to this study still contained important data. The broad mass of data was then organized according to the conceptual framework to bring out the significance and influence of the factors identified.

Using this material the first section analyses the role of small firms in the late Tsarist period. Surprisingly small firms were more numerous than the stereotypical image of Tsarist Russia suggests. The next task was to understand the opportunities that existed for small firms in the food-processing industry. Here the conceptual framework is used to structure the analysis of factors identified in chapter two under the categories of the political, economic and socio-cultural environments. The order with which these environments are discussed does not represent the supremacy of one over another. It was simply more pragmatic to examine the political environment first, because of the influence it had on the creation of the formal institutions, or the parameters governing the economic environment within which small firms were formed and operated. Through the discussion in this section it becomes apparent



that the state did little to facilitate small firm formation. Although state intention was to modernise Russia, to make it a country which could defend itself and be an equal with other countries in the developed West, conservatism and fear of invasion only served to stifle the very means that could have achieved this.

Following on from the political environment the next section is taken up with examining the object of state policies namely the shaping of opportunities in the economic environment. To this end it includes an examination of the economic geography of the Don region and the state's influence over the use of its natural resources. This section aims to understand the demands that existed in the economic environment for small firms to establish in the food-processing industry. This is achieved by looking at a variety of economic factors such as, the way the consumer market was developing, the availability of factors of production and the extent of transaction costs. As economic activity is also socially embedded the final section analyses the influence of the socio-cultural system on small firm formation. One important element of the analysis is the way class defined both the opportunity structure and the supply of entrepreneurs within that society. Briefly Tsarist social structure in this study is shown as restricting individual economic activity and initiative, at a time when it was needed most.

## **4.2. The Small Firm in the Tsarist Period**

The Tsarist period has a long time span from 1480 (the end of the Mongol empire within Russia) to 1917 (and the emergence of the Soviet state). This chapter is only interested in the period from which Russia industrialised; and this largely dates from the reign of Peter the Great, who was Tsar from 1694 and continues through to the Russian revolution. As this study is principally concerned with small firm formation, it was necessary to restrict the period of history examined to a time when



manufacturing in Russia took place in factories, rather than concentrate on the extreme small-scale industries of the craftsperson or artisan. Nonetheless, even with this reduction in time span, the Tsarist period covered in this work is still over two centuries, and means this study is unable to go into fine detail about the period, which it must be pointed out was not homogenous. The conceptual framework has helped to overcome this issue of time span by concentrating the analysis on certain factors considered as significant for understanding small firm formation.

Small firms are not immediately identified as characteristic of Tsarist industry; indeed it is generally known that industry at that time was large<sup>2</sup> and often state-owned. Certainly official statistics, especially from the late 1860s, confirm this (Crisp, 1976), having been collected on large-scale industries including coal, iron, steel, armaments, textiles and some sectors of the food-processing industry like salt and sugar processing and distilling, all of which were vital for supporting Russia's military. These statistics, because of the way they were collected by officials, overlook the many hundreds of small firms that existed (Crisp, 1976<sup>3</sup>). More to the point they help to explain why the Don region, during the first quarter of the 19<sup>th</sup> century, was characterised as having just a few industries organised into large-scale enterprises, one of which being the flour grinding industry (Gozulov, 1956).

This, however, contradicts evidence from Soviet sources of literature on the Don region, a significant food producing area with a few large firms but dominated by small-scale food-processing establishments. There are several reasons why small firms may have been more numerous than the statistics from that period indicate. Russia was a large country, which until the second half of the 19<sup>th</sup> century had an underdeveloped rail network and its poor transport infrastructure was incapable of taking perishable consumer goods to other towns and regions. Consequently the food market for a large part of the Tsarist period remained local rather than national.



Moreover, with the bulk of the population being poor, self-sufficient and living in small rural communities throughout the Tsarist period, there was little stimulus for the market (local or national) to develop. Poverty was probably more characteristic of the south, including the Don region, because its favourable climate when combined with serfdom prevented peasants from undertaking lucrative non-agricultural activities. So not only did southern peasants have less time for non-agricultural activities they worked under a system of '*barshchina*' where they were paid in-kind rather than with cash, which limited them to using the barter economy rather than the market for consumer purchases (including food). Consequently the market, even from the second half of the 19<sup>th</sup> century, was often adequately served by artisan industry. This weak market though, forced the state to use its autocratic power and become actively involved in the economy to create those large-scale industries necessary to fulfill its military aims (Falkus, 1972)<sup>4</sup>. Although large-scale industry never lost its importance, even during the last fifty years before the revolution, it was the small firm that continued to play a pivotal role in the economy (Crisp, 1976; Waldron, 1997; Dixon, 1999).

Estimating the contribution of small-scale industry to the Tsarist economy is complicated by its under-representation in official statistics<sup>5</sup>. According to Crisp official statistics stated there were some three and a half million *kustar* (cottage industry or handicraft) enterprises and artisan workshops in 1917. Other sources found by Crisp differed; one semi official publication estimated there were about 10 million in 1911 (Crisp, 1976). Even though these statistics differ and liable to be conservative they still provide some indication that small firm manufacturing was both widespread and important in Tsarist Russia (Dixon, 1999).

Small-scale industry first developed in the first half of the 19<sup>th</sup> century in response to the brevity of the agricultural season in the north and the need for serfs



to pay '*obrok*' (mostly money and sometimes in kind rent to a nobleman). This extremely small-scale cottage industry gradually grew and many villages in the northern less agricultural regions reduced their farming activities to specialise in some forms of industrial production. By the mid 19<sup>th</sup> century some villages had become centers of the textile, metal processing or leather industry (Timoshina, 2000). These origins of small firms in the north though were not replicated in the south, and this had as much to do with the long duration of the agricultural season as it did with the slow rate of colonization of the region.

The Don region's slow development of small-scale industry in the Tsarist period occurred as a result of only joining the Russian Empire relatively late and moreover remaining a disputed border area for some time after that. It was only in the second half of the 19<sup>th</sup> century, following the watershed event of emancipation in 1861 that the Don region began to develop. This event (together with the expansion of rail) subsequently facilitated a population increase in the town of Rostov-on-Don, which then led to an explosion in the number of food-processing enterprises, like flour mills, breweries, macaroni factories, tallow and fish preserving factories (Dzyubenko et al, 1979; Rostovskoe knizhnoe isdatel'stvo, 1957). This small-scale industry was able to exploit the region's comparative advantage in agriculture and fishing (Zolotov, 1974) and it was also the beginning of the region becoming known for its preserves (Pukhal'skii, 1972). Despite developing some large firms during the Tsarist period Rostov-on-Don, the region's principal town, had about 150 small industrial enterprises and 500 handicraft workshops at the beginning of the 20<sup>th</sup> century (Dzyubenko et al, 1979). Many of these small firms would have been in the food industry or concerned in some way with the processing of agricultural products, because agricultural processing was one of two main industrial sectors for Rostov-on-Don (the other being the metal processing industry)(Dzyubenko et al, 1979).



The picture then is one of late Tsarist Russia and the Don region having numerous small firms in the form of artisan or handicraft firms in rural areas and small industrial enterprises in towns. The next section focuses on the role of the state, its ideology and practices to examine how the state, through its formal institutions, influenced regional development and industry.

## **4.3 The Political Environment**

The political environment discussed below examines state ideology and state governance at the national and local level to understand how it shaped the demand for small firm formation in the economy.

### **4.3.1 The Role of State Ideology and Policy at National and Regional Levels**

The state in any nation shapes economic activity such as small firm formation through the institutions it creates. The types of institutions and the way they operate have much to do with the nature of the state and the way power is used. In Tsarist Russia the state was an autocracy, in other words there was one leader with unlimited power. Tsarist autocracy came into being to pursue two basic aims, firstly military security<sup>6</sup> and secondly modernisation. These aims governed the kinds of institutions that were created and the economic policies that were pursued up to the First World War. Before examining economic policy, it is necessary to understand the historical events, which gave rise to Russian autocracy during the Tsarist period because it provides one explanation for the difficulties members of society encountered in displaying 'entrepreneurial' behaviour through small firm formation.



Historians continue to dispute the roots of Russian autocracy and whether it originated from a time when Russia was under Mongol rule between 1240 and 1480 (Hosking, 1992). Rather than Mongol rule, some historians consider that Russian autocracy was a necessary defensive reaction to the lack of natural borders, which made Russia susceptible to invasion (Kochan and Keep, 1997). Whatever the truth following the withdrawal of the Mongols, Russia soon created a centralised government and a powerful state under an autocratic leader. Some legacies from the Mongol period that appear to have been inherited into Tsarist Russia include taxation and the appointment of regional governors approved by the ultimate leader (Timoshina, 2000; Kochan and Keep, 1997; Treadgold, 1995). If Kochan and Keep are correct then serfdom and autocracy were not in evidence during the Mongol occupation, but were a reaction to the constant threat of invasion and a mass population endlessly fleeing from authority (Kochan and Keep, 1997). Another characteristic of post-Mongol rule was state driven modernisation through the promotion of the defence industries. Mongol occupation contributed to this need for modernisation because it caused Russia to miss out on the renaissance movement, with its technological innovations that had swept through Europe, and instead fuelled a sense of inferiority and the need to catch up. The drive to catch up though did not mean that industries in the consumer sector would also benefit from a state ideology that concentrated on improving industrial development for strategic reasons.

Tsarist autocracy then determined not just how Russia was governed, but more importantly for this study the kinds of economic policies that were implemented.

### 4.3.2 National and Local Governance

Tsarist autocracy created a centralised decision making form of governance based on national ministries. The heads of ministries were appointed by the Tsar from



members of the nobility, who in turn appointed lower members of the bureaucracy from the nobility and merchant guilds (Lewin, 1985). This had two consequences. The first and most important was that the Tsars orders, irrespective of their quality, were carried out by individuals whose positions were dependent on their obedience to the Tsar. The second consequence was that the status quo was reinforced and radical modernising ideas (unless coming from the Tsar) were ignored, with the result that industry for much of the Tsarist period was run conservatively. In addition it largely suppressed the influence of local levels of governance on the way regional industry developed.

From the late 18<sup>th</sup> century local governance at *guberniya* or town level existed, but only because expansion of the empire made it impossible for the continuation of direct control from the center. As with the national level of governance, representatives in town *dumas* (later *zemstvos*) were chosen from members of the nobility and top guilds of merchants. Like governance at national level, local governance contributed to keeping power in the hands of the aristocracy to reduce the introduction of policies that might disturb the balance of power. As a result some historians such as Hosking (1992) find that local governance was on the whole very weak, and often incapable of carrying out orders that came from the center. This view though ignores the many limited achievements that local administrations were able to make. Although local administrations were prevented from developing their own industrial policies, they indirectly helped local business and industry when they successfully implemented national policies. This was because they were charged with building hospitals and schools, developing urban transport, lighting and paving streets, and improving public hygiene and health (Kochan and Keep, 1997). These measures helped industry increase productivity, transport their products, increase sales and employ healthy educated workers. Consequently what the local administration was able to do for regional industry very



much depended on the central administration (Hosking, 1992). Beyond the implementation and administration of nationally drafted policies local governance remained weak, having no creative political role and a limited capacity for making independent decisions.

Although the local administration could be described as weak, approval from it was still needed for business activities. Unfortunately getting approval was complicated. Despite nationally directed parameters governing this decision making process (such as which industries were favoured), bureaucrats had a certain amount of discretion, which when coupled with their bad pay and a system that tolerated corruption and intrigue, meant that local business people were often compelled to pay bribes. This is the beginning of a tradition that has proven to be very long lived. To sum up governance at the national and local level can be interpreted as having a conservative, even stifling rather than enabling or encouraging influence on small business throughout most of the Tsarist period. This becomes even more evident when analysing the function of state economic policy.

### 4.3.3 Economic Policy

Economic policy in the Tsarist period was preoccupied with maintaining the security of the country rather than developing consumer industries. This aim, together with the Tsar, being the only person with the right to unlimited use of land and how Russia's resources could be used, defined the general direction for the development of Russia's domestic industry (Sushchenko, 1997; Kochan and Keep, 1997; Hoskings, 1992). The state focussed predominantly on stimulating the defence industry (Hosking, 1992) and companies set up privately or by the state within it, were obliged in the first place to fulfil state orders (Sushchenko, 1997). State orders tended to consume all of the output, there was little left over to sell elsewhere, even



had it been suitable for the domestic consumer market. Consequently only those sectors of the food-processing industry that were providing basic products for feeding the military and the Tsars court, received sufficient stimulus from the market to develop into factories larger than artisan workshops and this accounts for why most industry remained small-scale. Moreover, it provides some indication of the state's influence on the development of industrial sectors in Tsarist Russia.

For a large part of the Tsarist period the state had extensive control over industry. The Tsar's authority was absolute with the effect that the law placed no formal limits on it (Shanin, 1986). This was reflected in the Tsar's extensive property rights, but it was also evident in the way the state controlled the judicial system until their separation in 1864 (Kochan and Keep, 1997). Consequently for much of the Tsarist period not only did the various social groups have restricted property rights, but the power of the Tsar and his state went unrestrained. Even the nobility, who were an important element in state social control, had insecure rights over their estates and property until 1785 (Rieber, 1982). At the other end of the social scale the peasantry had the fewest rights. Serf peasants (compared to state peasants) could be sold, sent into the army, told whom to marry, and punished at will (Sushchenko, 1997).

The most damaging aspect of property rights in the Tsarist period was the effect it had on the incentive system of the various social groups to invest in industry and business. This was particularly evident in the business activities of merchants, who despite having extensive market knowledge did little to exploit it and remained conservative in business. Part of the reason for this was to avoid the attention of the Tsar or bureaucrats, because whilst bureaucratic decisions were often favourable they could sometimes push a merchant family into destitution. As happened when merchants were forcibly moved around Russia, or when their businesses were



confiscated (see section 4.5.1 on Social Groups). The way the state made decisions suggests that economic policy could be arbitrary, which must have contributed somewhat to dampening the development of independent non-state business and industry in Tsarist Russia. This situation did not change until the mid 1860s when judicial reform provided some protection from state abuse and allowed a professional advocacy to develop. Despite these important changes the continuation of a still frequently corrupt and partial judicial process ensured that many judgements were not free of the Tsar's influence (Kochan and Keep, 1997).

The Tsar's influence was evident in the predilection towards large manufacturing firms, though this 'love affair' with large factories waxed and waned from time to time over the years. Prior to the French Revolution large factories were considered vital to supply the armed forces, but afterwards they were viewed more suspiciously as breeding grounds for insurrection and increasing internal insecurity (Crisp, 1976; Blackwell, 1994). This fear was short lived, and by the end of the 18<sup>th</sup> century more large factories were set up. Gradually state control of large industry lessened (Timoshina, 2000), but the real break of the state from industry only occurred after 1861<sup>7</sup>. From then on industry was dominated by private as opposed to state-owned firms (Mckay, 1970). This did not mean that the state had lost its influence on industry, on the contrary the state still exercised its power on industry through its manipulation of the banking system (see section 4.4.2 on the Availability of the Factors of Production).

The state apart from directly influencing industry through ownership also employed indirect means to control industrial production. The two most important elements of indirect state control were tariff and fiscal policies. Neither of these policies or institutions could be said to have been particularly successful for the defence or consumer industry. Although the intention of the state with its tariff policy



was to protect its important industries from international competition, all it did was to encourage the formation of domestic monopolies and reduce the incentive to innovate. State fiscal policies, on the other hand, were supposed to increase revenue to the treasury; but taxing the poorest yet largest social group dampened consumer demand, which in turn stifled industrial development and kept revenue low. State economic policy then effectively reduced the need and opportunities for commercial production, with the result that small firm formation and activity in the consumer-manufacturing sector, other than at a micro level, was not encouraged.

The emancipation of the serfs in 1861 heralded the beginning of important reforms to state institutions that eventually contributed to the increased urbanisation of Russia and its concomitant demand in the economy for the development of the consumer industry. This in turn created a need for a new capitalist or bourgeois class in a small but active capitalist sector (Lewin, 1985). As the next section will show this institutional change created new opportunities in the economic environment in the second half of the 19<sup>th</sup> century.

## **4.4 The Economic Environment**

The economic environment was not only shaped by state institutions, but also by a number of economic factors, including the availability of factors of production, the development of the consumer market and the changing pattern of demand as well as by the way that space within regions was used. The conceptual framework acknowledges these as important influences on the way that industry and especially the food industry developed in the Don region. The first point to be discussed is the role of geography and its impact on the development of the food-processing industry in the Don region.



### 4.4.1 Geography and the Transport Infrastructure

Geography and the location of natural resources were important influences on the way industry developed in the regions during the Tsarist period. Until the expansionist policies of the 16<sup>th</sup> century Russia lacked a stock of natural resources and favourable agricultural land<sup>8</sup>. Even as the empire grew and gave access to additional resources, the sheer distances between where related resources (such as iron ore and coal) were located from each other, and between them and where the Tsar and his court were could not be overcome until the mid 19<sup>th</sup> century when rail travel developed (Heyman, 1993; Treadgold, 1995; Blackwell, 1994). Until then industry remained dominated by rural handicraft workshops (Blackwell, 1994). One place that shows the influence of geography on economic development is the Don region.

The Don region only became a part of Russia after 1696<sup>9</sup>; even then it was an unsettled frontier region until 1774<sup>10</sup>, when the border moved further south. Insecurity and the military obligations of its population prevented industry from taking advantage of this region's fertile agricultural land and large stocks of other natural resources. It was only in the second half of the 19<sup>th</sup> century following emancipation, the expansion of rail transport and the further development of its own heavy industry, that trade in agricultural and processed food products was stimulated by growing towns both inside and outside this region (Zolotov, 1974; Rostovskoe knizhnoe izdatel'stvo, 1971; Dzyubenko et al, 1979; Brovkovich et al, 1968)<sup>11</sup>.

Apart from having a comparative advantage in agricultural production, the Don region's location enabled it to become an important strategic transport centre. The River Don provided access to Europe, the Mediterranean and the Middle East. Though until the development of rail it was not always easy to exploit these valuable



trading connections, because contact with central Russia was hindered by rivers like the Don flowing in the wrong direction (Baykov, 1954). Consequently transporting large amounts of grain, coal and other natural resources any significant distance remained costly and time consuming for much of the Tsarist period<sup>12</sup> (Blackwell, 1968; Falkus, 1972; Blum, 1967). Transportation was further complicated when those seas, ports and navigable rivers froze up in winter or dried up in summer. The river Don for example is closed by ice for 3-4 months a year (Baykov, 1954). Even canal construction to unite the South with central Russia was prohibited by cost and technical difficulties (Crisp, 1976; Baykov, 1954; Dzyubenko et al, 1979). Travel overland was also not without difficulty because during spring and autumn unpaved roads became bogs and mires<sup>13</sup>. Consequently it was not unusual for food to be left rotting in fields in surplus producing regions, like the Don region, whilst in other parts of the country there was a deficit (Blum, 1967). So the expansion of the rail system in the 19<sup>th</sup> century was vital (Heyman, 1993; Treadgold, 1995; Blackwell, 1994). Not only did it connect the Don region in the agricultural south with markets in the central region, but it stimulated local consumer markets, urbanisation, and the development of new food-processing sectors to serve them (Timoshina, 2000; Dzyubenko et al, 1979).

The result was the development of the food industry in the Don region that served the national market; and which by 1913 had one quarter of all the region's factories employing 13.7% of all workers, or 17.1% of the population, and was producing 40.9% of the region's industrial production (Brovkovich et al, 1968). Nonetheless primitive technology, especially in preserving and packaging, restricted the development of some sectors such as the meat and dairy industry causing them to remain local and backward (Danilova and Mukhina, 1960; Burgeinyi et al, 1979). Even though technology was limited the Don region gradually became a nationally important agricultural and food-processing region in Russia, but its geographical



location was not the only reason for the food industry's development, ease of access to factors of production was also significant.

#### 4.4.2 The Availability of the Factors of Production

The conceptual framework emphasises understanding how the availability of factors of production, (*land* including premises, *labour*, *finance*, and raw materials or *inputs*) shaped economic activity during the Tsarist period. These four factors of production were not readily available in Russia until after the watershed year 1861. Before that date the state had monopoly control of land, it restricted the development of banking, and controlled the population through a policy of universal bondage which contributed to limiting the amount of labour available for factories. Factories around this time in Russia were labour intensive, largely as a result of their low technological base so access to a sizeable labour force was important. Moreover other inputs were difficult to obtain because the weak market provided little information about accessing them, and the poor transport infrastructure, even between relatively short distances, made it difficult to combine labour and natural resources in industrial production.

Even had labour and inputs been easy to combine in industrial production land and all property rights over it belonged to the Tsar and the nobility who were reluctant to lose their monopoly over them (Kochan and Keep, 1997). Therefore land and property rights were not readily available to anyone else for the development of business and industry. Emancipation helped change this, so that by the beginning of the 20<sup>th</sup> century it was not uncommon for peasants to buy their own land and to have full property rights over it and the resources it produced. The reforms that were introduced from the 1860s onwards did not just affect property rights; they affected the supply of labour too.



Emancipation in 1861 had a significant effect on the availability of labour for industrial factories. Prior to this date industrialists were reliant on the support of the state and the Tsar for the transfer of peasant workers from agriculture (Heyman, 1993). The state did alter some institutions to help industrialists obtain employees, for example peasant workdays were restricted in law to three days a week, and after 1721 industrialists (more often merchants) were allowed to buy up estates and their peasant labour forces (Kochan and Keep, 1997). The problem was that these measures were either difficult to enforce or were simply not sufficient to ensure a large enough labour force was available; this was especially so in the south where agriculture was so productive. It was only after emancipation that a steady flow of migrant peasants, from rural areas to low paid jobs in factories located in towns, enabled industry to grow (Kochan and Keep, 1997).

Access to labour and land were not the only problems facing potential small firm industrialists during the Tsarist period. The other main factor, which acted as a constraint on any entrepreneurial response, was lack of capital. Up until 1860 industry's capital requirements were more than adequately supplied through usury (Garvy, 1972; Crisp, 1967). This was because banking had been deliberately restricted by the state due to its fear that a growing industrial proletariat might be influenced by the French Revolution (Sushchenko, 1997). It was the need to expand the rail system that eventually contributed to an increase in the number of banks.

Banking started to develop in the 1890s but under state control, which meant that the state, through bank loan practices, was able to continue influencing the development of industry (Blackwell, 1994; Sushchenko, 1997). The state did more than influence the manner of industrial development, it determined which groups in society were able to exploit the new opportunities that were emerging as a result of institutional change. Although institutions were changing, old attitudes in the late 19<sup>th</sup>



century still resisted the notion that some groups in society should be able to accrue wealth through business (Khor'kova, 1998). Social attitudes (which will be discussed in more detail in section 4.5.2, The Cultural Environment and its Influence on Business Activity) made it far easier for the nobility to access bank loans with long loan periods at low interest rates than other groups in society.

Lack of capital was one contributory factor slowing down the development of industry in the Don region during the 19<sup>th</sup> century. It was only with the setting up of foreign owned enterprises and firms moving from central Russia towards the start of the 20<sup>th</sup> century, that the number of credit institutions increased. As elsewhere in Russia, banks in the Don region gradually became more involved in large business by gaining control of a number of sectors (either through setting up industries or becoming a major shareholder)<sup>14</sup>. Interest in large monopolistic firms may help to explain why small firms continued to struggle finding working capital or credit, the lack of which forced some to exit from the market (Crisp, 1976). Banks then, especially in urban areas, where they were located, shaped the industrialisation of Tsarist Russia (Garvey, 1972; Kochan, 1977). They were much less visible in rural and major food producing areas, which may explain why there was a need for co-operative banking to fill the gap and act as an alternative source of capital, especially for peasants. It appears that banks were less involved with small food-processing firms in rural areas, not because of their low levels of profitability but because their interest in large firms may have prevented them from lending to potential competitors in a market where demand was weak.

Credit co-operatives or societies made loans to small peasant producers for the development of farming activities or artisan workshops. Certainly they contributed to an increase in peasant land purchases at the end of the 19<sup>th</sup> century, which also indicates that opportunities for increased agricultural production must



have existed and that the peasantry was not incapable of exploiting it. Apart from lending, co-operative banks also offered other important services to peasants, which must have been difficult to obtain through the market such as intermediation and storing grain until market prices rose (Kozlova, 1993). Consequently co-operative banks were important in stimulating the involvement of the peasantry in the entrepreneurial process. Moreover, the success of these organisations was instrumental to the development of private farmsteads after 1907 and the proliferation of small food-processing enterprises in the Don region. Certainly one can conclude that on the whole the development of co-operative private banking did widen access to credit, which ultimately contributed to the development of new industries in the second half of the 19th century (Timoshina, 2000)<sup>15</sup>.

The economic environment before 1860 was too hostile for private manufacturing firms to establish. There were limited opportunities to obtain sufficient factors of production, the poor transport infrastructure and the distances between towns and villages meant that there was insufficient demand for any products produced and there was limited opportunity to obtain inputs. It was only around 1860 following the various reforms of this period that factors of production became more widely available, and transaction costs associated with setting up and operating a firm began to fall. This coincided with an improvement in the transport infrastructure, which contributed to creating national and regional food markets and provided more opportunities for enterprise. The emergence of co-operative banks in rural areas was especially useful to small firm owners, and was a key factor in their survival. Nonetheless the development of the consumer market, remained slow at best and continued to be an inhibiting factor right through to the early 20<sup>th</sup> century.



### 4.4.3 The Development of the Consumer Market

The one factor above all that shaped the way the food-processing industry developed was the low level of demand in the consumer market, with industry in all consumer sectors often hitting a ceiling of demand for their products. Various factors slowed down the development of the consumer market. These included high taxation levels and self-sufficiency of the bulk of the population together with a widely dispersed rural population (Baron, 1983)<sup>16</sup>. The peasantry in many rural areas even following emancipation in 1861, was paid in kind with agricultural goods that were consumed rather than sold by the household (Shanin, 1986). This meant that for a large section of the population, there was no access to wages in return for labour (Kahan, 1994). As a consequence the rural population had little disposable income and minimal purchasing power, limiting the expansion of the consumer market. Demand did gradually increase over time for manufactured goods including processed food products. This followed the growth in towns from military garrisons during the 17<sup>th</sup> century (when booths and stands sold a few articles), but was especially in response to the expansion of the rail system at the end of the 19<sup>th</sup> century (Kochan and Keep, 1997). Despite the growth of urban areas they still remained small having just 18% of the population even up to 1914 (Lewin, 1985; Falkus, 1972)<sup>17</sup>.

The growth rate of urban areas with their potential consumer markets differed depending on their geographic location. Towns in agricultural regions of the south (where the Don region was located), on average were much smaller than towns in the north, having just 6.8% of the population in 1885 compared to 17% in the north (increasing by 1897 to 9.4% in the south and 19% in the north) (Donnorummo, 1987). This affected the potential of the consumer market, which was also affected by indirect taxation keeping prices of many luxury products (including sugar and alcohol)



artificially high so that few consumers, other than the rich were able to purchase them (Timoshina, 2000; Blackwell, 1994; Kahan, 1994). The urban consumer market remained small-scale right up to 1917, and annual or itinerant fairs (often held to coincide with church holidays) continued to be the principal means of distribution (Kochan and Keep, 1997).

The economic environment then lacked the capability to support independent small business in the consumer sectors, especially before the 1860s. This was largely because the mass of the population was enserfed and highly taxed. It was only with the development of rail in the late 19<sup>th</sup> century that a nascent consumer market was encouraged to develop by industrialists able to overcome geographical hindrances such as large distances and a widely dispersed population. This happened at the same time as increased urbanisation and improved access to factors of production, which enabled many industries to develop in a variety of sectors to fulfil new demands in the economy for consumer goods.

One way, according to the conceptual framework, to assess the impact of the economic environment on the development of the food industry in Tsarist Russia generally and the Don region specifically is to establish the nature of transaction costs facing business. This is the subject of the next section.

#### 4.4.4 The Role of Transaction Costs in the Economic Environment

The above section on the economic environment has shown the difficulties that existed for the private industrial sector in Tsarist Russia. The failure of the market to stimulate industry and exchange suggests that transaction costs were particularly high both at a firm's start up and during its operation. As chapter two states



transaction costs are the aggregation of non-market or intangible costs incurred through exchange and are additional costs associated with all the factors that have been analysed above in the economic and political environment sections. These non-market costs reflect the amount of time and effort that is spent on simply attempting to enter into and operate on the market. What is evident from the above analysis is that state institutions worked to prevent many sections of society from being able to enter business exchange relationships. Consequently transaction costs were high, and even though they fell as a result of reforms to some basic institutions and the expansion of rail in the second half of the 19<sup>th</sup> century, their influence was still apparent. This was because poor legal protection and the activities of bureaucrats and the state caused business to remain insecure right up to 1917.

The most important factor keeping transaction costs high was the activity of the state and its bureaucrats. The state failed to create an economic environment in which transaction costs were at the same level for all firms. For vital large firms it lowered many transaction costs incurred when accessing any factors of production and by being the main consumer, in other words the state compensated large firms for the weakness of the market. In the food industry the sectors able to reduce transaction costs in this manner were milling, sugar and salt processing, because they supplied the armed forces. Other food sectors could not take advantage of state actions to reduce these intangible costs. They had to wait until they could be partly compensated by a growth in consumer demand and the opening up of both local and national markets through improvements in transportation. So the state whilst not openly discouraging other sectors in the consumer industry and small firm formation, was not active enough in reducing transaction costs sufficiently to encourage widespread economic development.



Apart from the weak market keeping transaction costs high there were costs incurred by the uncertainty created from a corrupt judicial system. So although changes were made to property rights, legal protection remained inadequate, and citizens' interests were still insufficiently protected against the Tsar, bureaucrats and other economic agents by the early 20<sup>th</sup> century. Poor legal protection was one of the main factors keeping business conservative, both in trade and manufacturing. But it was not just poor legal protection, it was limited social protection and insurance protecting capital investment, important when status depended on one's role in society and when access to finance was also limited. High transaction costs then contributed to keeping the food sector in the Don region both small-scale and technically underdeveloped, despite the its comparative advantage in agriculture.

State actions did not just affect transaction costs and the demand in the economy for entrepreneurship by shaping the opportunities that were available, the state also determined the supply of entrepreneurs through its social policy. As will be seen in the next section the state engineered the social groups that existed and the incentives for members of these social groups to engage in non-state economic activities.

## **4.5 The Socio-Cultural Environment**

Under the broad heading of the socio-cultural environment will be discussed factors affecting the supply of entrepreneurs for setting up new small firms. This section will first examine the various social groups that existed in Tsarist Russia and the opportunities they had to become potential entrepreneurs. Then it will analyse such informal institutions as social attitudes towards individuals engaging in business as well as the role of social values and trust on business behavior.



### 4.5.1 Social Groups

The socio-cultural environment was shaped by the state, which divided people up into social groups each with accepted activities, duties and obligations (Rieber, 1982<sup>18</sup>). This form of social engineering by the state determined which social groups (both 'insiders' and 'outsiders') were allowed to engage in business activity and which sectors of the economy were open to them. 'Insider' groups included the nobles, merchants and peasants whilst 'outsiders' included minority groups, that for one reason or another were distrusted by the state and victimised as a result. Russians who wanted to engage in business, therefore had to adapt to the realities of their social status (Khor'kova, 1998). The state's social engineering consequently had an important impact on business and industry. Moreover, this section will show that the state appears to have actively encouraged a feeling of distrust between (and amongst members of) social groups and this negatively affected the development of business and industry (Rieber, 1982; Crisp, 1967; Shanin, 1986).

The nobility was an insider group, with opportunities to set up industrial production in the form of estate (*votchinal*) factories, to engage in money lending and in foreign and domestic trade (Blackwell, 1968). Undertaking industrial production was eased for them by a supportive state policy (Blackwell, 1968). The state favored this group's involvement in industry for two main reasons. Firstly their status consigned them a certain amount of power and access to privileges, which because they could be withdrawn, obliged them to be obedient subjects to the Tsar. Secondly, this group was useful in controlling the lower social groups. The state was continually nervous about the activities of the bulk of the population, so the nobles to whom this section of society were enserfed, were an important instrument of social control.



The nobility made use of the vast amount of labour and raw materials available on their estates to support their own lifestyles and social status, but this did not mean that they invested and developed their industries. The underdevelopment of estate factories and agriculture was common, and was largely due to the stigma associated with business and industry (rather than, according to Marxist historiography, solely consumption) and also partly connected to the limited time available to develop them after fulfilling service obligations to the Tsar (Kochan, 1977). The cultural discrediting of business seems to have happened gradually, which may explain why before the 19<sup>th</sup> century it was common to find the nobility, with state help, monopolising distilling<sup>19</sup>, timber, oil and sugar refining, iron production and textiles (Blackwell, 1983; Rieber, 1982). The state<sup>20</sup> helped the nobility by consuming their products, providing subsidies often through paying fixed prices (Blackwell, 1994), and supplying capital. The downside of guaranteed state consumption was that there was insufficient incentive for the nobility to develop their industries and businesses. The state's unpredictable dealings with business may have also contributed to the growing stigma that was attached to business for the nobility. Moreover, it appears that such state actions were strategic to prevent some businesses and especially merchant businesses from becoming too successful, though it subsequently had a negative impact on noble businesses.

The merchantry was another 'insider' social group, unable to take advantage of their access to capital, markets and market knowledge to exploit industrial production in the consumer sector. Like the nobility they had opportunities, but they also had to contend with constraints. One such constraint was the guild system, to which they were obliged to belong and which dictated the nature of their economic activities. Only merchants from the first guild were allowed to engage in industry, although this did eventually open up to the second guild<sup>21</sup>. The merchants in this guild tended to start off in metallurgy, then moved into the nascent consumer sector



such as linen, silk manufacturing and in particular alcohol distilling (which they dominated until 1754 when the state assigned this industry to the nobility). There were few merchants involved in industry initially, but their numbers gradually increased, often through state coercion to develop the military industrial sector. In 1765 just 2% of Moscow's merchants owned factories, by 1849/50 this figure had increased to 90% of merchants in the first guild and 59% in the second guild (Blackwell, 1968).

The state manipulated the merchantry through its offers of support in the form of subsidies and by providing access to products such as fine furs for the merchants to trade with (Rieber, 1982). This way the state obtained merchant acquiescence, but the state could just as easily take away this support, and it demanded total obedience. The autocratic state, for example in 1711 forcibly moved merchants to the new capital of St Petersburg to encourage the development of trade there. This however irreparably damaged the trading links of many of these merchants and caused them financial hardship (Sushchenko, 1997). The state could not be prevented from doing this because like all social groups merchants lacked full property rights; consequently they and their businesses were subject to the wishes of the state. The uncertainty about the continuation of state support (Rieber, 1982) and the nature of state interference in their businesses increased both financial and personal insecurity, encouraged conservatism as a way to protect their interests and reduced the incentive to develop their economic activities, even when opportunities were available.

Insecurity meant that merchants were less inclined to move out of trade into industry, because trade offered quick returns on capital that could be effectively concealed from the state (Sushchenko, 1997)<sup>22</sup>. As the state limited profit earnings merchants had to be coerced through threats (of fines and imprisonment) into setting



up industrial firms. This simple act by the state only reinforced the merchants' status as chattels of the Tsar and by association discredited the concept of business and industry (Sushchenko, 1997; Blackwell, 1968)<sup>23</sup>. More importantly the businesses often proved unprofitable. Lack of profitability was not helped by the activity of the state, which dominated the market consuming whatever was produced irrespective of quality, leaving no surplus for sale on markets abroad and at home even had the quality been better. Consequently there was little incentive to develop industry and many potential manufacturing opportunities were lost (Sushchenko, 1997; Gradov, 1997; Baron, 1983). So reliance on the state together with fear of the state and its actions contributed to making Russian merchants risk averse.

The state was not the only negative influence on the business activities of merchants. Lack of insurance, poor protection of trade, and the inability to legally enforce business obligations meant bad business decisions could potentially be disastrous for the merchant and his family, by wiping out wealth and lowering social status<sup>24</sup>. The fortunes of businesses were also threatened when merchants were periodically taken away to fulfil their state service obligations<sup>25</sup> (Rieber, 1982). Consequently the social system and the absence of a social safety net acted as disincentives to entrepreneurship for this group.

It was the lowest social group with the fewest rights of all that made the most of their limited opportunities to engage with the entrepreneurial process. The peasantry,<sup>26</sup> were not free agents they belonged to the state, Tsar, nobility or the monasteries<sup>27</sup>. Up to 1861 all peasants, whether they were privately owned (serfs) or not, had no property rights over the land they worked nor by law did they have rights over their own personal liberty<sup>28</sup>. Moreover, where a peasant lived in Russia, whether it was north or south influenced the opportunity they had to develop non-agricultural economic activities.



It was the estate peasants in the north who had the most non-agricultural opportunities. The short agricultural season in the north and the need to pay obrok was the impetus peasants had to find other activities, such as handicraft cottage industry and trade. The barriers to trade for peasants were reduced by the beginning of the 19<sup>th</sup> century encouraging more into it<sup>29</sup>. From trade, some peasants developed cottage industries through the putting-out/buying-up system, where they organised other peasants to work from home to produce goods for sale, in return for raw materials, other goods or money (Shushchenko, 1997). At this time this small-scale handicraft industry did not need large amounts of capital (Timoshina, 2000), though it sometimes grew with the help of nobles into larger sized factories. This was not experienced throughout all of Russia; in the south where the Don region is located, the length of time spent on agriculture and the system of barshchina meant that nobles were able to make sufficient income from the land.

Serfdom was in itself not a disincentive to peasants developing independent economic activity (Gatrell, 1992), rather it was geographical location and who owned the serfs. Some historians comment that the success of northern estate peasants was not replicated by northern state peasants<sup>30</sup>, despite their greater personal freedom, lower tax burdens and better land provision (Crisp, 1976). For estate peasants, serfdom provided some protection from the arbitrary behavior of the state and overburdensome taxation. In addition estate owners provided access to factors of production, which others such as state peasants did not have. In other words many estate peasants faced lower transaction costs for starting up and growing a business compared to other peasants. It is though still not possible to determine how widespread the serf factory was. Nonetheless, although some landlords encouraged some peasants to develop industries, it was likely that social constraints, lack of education and the demands of agriculture, meant that peasant industry was not widespread, was very small and underdeveloped. Those factories that did grow



would have been in the minority and in isolated pockets around the country preventing peasant industrialists acting as role models to others.

Even after 1861, when the serf peasantry was emancipated, many historians claim there were fewer rather than increased opportunities<sup>31</sup>, as a result of higher tax burdens in the form of redemption payments that had to be made on land transferred to them (Kochan, 1977; Donnorummo, 1987; Gatrell, 1986; Volin, 1965). Moreover, the village *obshchina* (also known as commune or mir) had the authority to prevent many peasants from moving to urban areas to find financially more lucrative industrial employment and from developing their parcels of land as they wanted. Even after 1861 the peasantry still did not have full property rights over land. Emancipation it seems was as restrictive as serfdom had been. This though is just one view, another expresses that the commune was more progressive than traditional analysis considers to have been the case.

Some historians comment that the commune was not dominant throughout the Russian Empire, the periodic redistribution of land did not always happen<sup>32</sup> and the economic burdens on the peasantry were not always higher than they had been pre-emancipation<sup>33</sup>. Serfdom had according to them been a flexible institution allowing peasants to pursue a variety of activities in both trade and industry. Hence there was a strong likelihood that the commune too would have been flexible, allowing many peasants to find and exploit new opportunities<sup>34</sup> (Gregory and Stuart, 1992), especially when more profitable activities in the towns helped with the redemption payments. Also high land prices, rents, and an increasingly specialised peasant agriculture were indications that a food market was developing, and that peasants were responding to its signals (Gregory, 1992; Timoshina, 2000). In addition peasants were also finding work in new industrial towns, facilitated by the expansion of rail, which transported food to them. By the end of the 19<sup>th</sup> century the



peasant class was becoming a source of supply for entrepreneurship, albeit on a limited scale and heavily constrained by the law and peasant customs.

The above was an analysis of groups within 'official' Russian society. Before 1860 none of the above groups were particularly entrepreneurial and all made only limited contributions to developing the food-processing industry. There were other groups, which were socially marginal due to their ethnic origins or religious background for example Jews, Old Believers, Armenians, Germans and so on. These groups existed as a result of the Russian Empire expanding into new territories (Rieber, 1982) or in the case of the Old Believers because they did not accept the changes made to the Orthodox Russian church. Irrespective of why they were outsiders they shared several common features. Being outside the formal social system, these groups were not forced to undertake particular duties or obligations. Consequently they had more time to engage in trade and industry. This engagement with the economy made them important to society and was a reason why most of their oppression was political rather than economic (Rieber, 1982).

Their persecution by the authorities and their outsider status meant these social groups did not have access to existing sources of capital or state patronage. To be successful in Tsarist society, members of outsider groups organised themselves into smaller self-help societies or associations. This was the way they pooled capital to support involvement in trade and industry. The result of which was that some members of these groups became successful industrialists, bankers and traders by the beginning of the 20<sup>th</sup> century.

In the Don region the predominant outsider group was the Cossacks, made up of various ethnic minorities and escaped serfs, who established communities and, in return for being left alone, served in the army. In the Don region the Cossacks



principally engaged in agricultural production, there is no evidence suggesting they were involved in industry such as food-processing<sup>35</sup>. This should not be surprising as Cossack culture venerated war and hunting (activities that support a less constrained form of existence) over industry with its more structured lifestyle (Sushchenko, 1997). Moreover, with their military obligations there was little time available for Cossaks to engage in industry. Trade was the only feasible business option for them and accounts for why they gradually became more involved in it by the end of the 19<sup>th</sup> century, though trade still remained of secondary importance to agriculture (Sushchenko, 1997).

After 1861 society changed, opportunities arose in all sectors of industry including the consumer industry, but many remained under exploited and this has been attributed to the continuing old social divisions, cultural traditions and habits (Lewin, 1985). The law had changed quickly, but broader institutional and social change failed to keep pace, leaving the old ways of conducting business and social distinctions still intact. The nobility for instance continued to dominate the polity, especially the imperial court and the upper layers of the bureaucracy (Lewin, 1985), and this slowed down the pace of change for lower social classes. Those lower social classes that were engaging in business and industry in the years leading up to the First World War, consequently remained politically immature because of their lack of political experience, conservative in business and dependent on state protection (Lewin, 1985). Consequently the way Russian society was organised helped to shape the exploitation of opportunities within industry and business and the risks individuals were prepared to take.



### 4.5.2 The Cultural Environment and its Influence on Business Activity

Russian culture shaped the kinds of economic activities that were acceptable for each social class and its respective customs and habits. Social change though was much slower than institutional change; consequently even after emancipation most peasants remained on the land despite their new rights. Cultural factors then combined with low levels of social and legal protection to make some business activities appear too risky. Reforms to formal institutions were inadequate for stimulating economic development and they combined with the slowly changing informal institutions to preserve conservative<sup>36</sup> business practices. This resulted in merchants refusing to use the new promissory notes<sup>37</sup> and the rail system, and peasants being slow to use the three-field system and try new crops such as the potato<sup>38</sup>, let alone venture into other areas of business or industry.

The members of the different social groups then tended to stick to the economic activities that were socially accepted for their status. The autocratic system then was successful in controlling society<sup>39</sup> and even restraining internal revolution such as peasant uprisings, but the social attitudes it encouraged had a dampening effect on entrepreneurship. The stigma attached to business and trade occurred because they were taxed by the state at a time when taxation was associated with low social status. As taxes were mostly paid by peasants and merchants, anybody, including nobles engaged in commercial activities, paying taxes was by association held in low esteem (Black, 1983)<sup>40</sup>. This provides an explanation for the low numbers of nobility involved in trade and business and why, by and large, they failed to develop their estate factories. Building a business and paying taxes would have been seen as running counter to the values of the nobility (Rieber, 1982).



Taxation was not alone in tarnishing the allure of business and industry, another was the poor business practices of trades people especially merchants in the third guild who were accused of fleecing both buyers and sellers<sup>41</sup>. Bad business practices resulted in a growing negative attitude towards anyone involved in trade and not just merchants but also serfs or Old Believers (Blackwell, 1983). Trade or business of any sort increasingly became associated with dishonesty, fraud, forgery, false measures and secrecy (Owen, 1983). The merchant business reputation was not just sullied through trade, but by their other social role as tax collectors<sup>42</sup>, even though one could argue that the nobility by controlling the peasants was the greater exploiter. It seems that the negative connotations associated with business and the lower social classes were probably useful for the nobility and the bureaucracy, who may have felt their positions of power being threatened by the potential success of the lower social groups (Sushchenko, 1997). So negative attitudes to business served as a means to prevent the lower social classes from achieving power in Tsarist society.

This negative attitude towards business was partly responsible for low trust levels within business. The next section looks at the historical origins for low trust in Russia, which has continued to exert an influence on the behaviour of business through history and into the 1990s. It will include an examination of the state's role in influencing trust levels in both society and business. One conclusion to be drawn from the next section is that low levels of trust contributed to restricting business and industry from making the kinds of advances that were seen in other western countries.



### 4.5.3 Trust in Business and Society: A Key Factor

The conceptual framework emphasises that lack of trust stems from having a centralised (corrupt) state and a weak civil society with low numbers of non-governmental organisations. Russia was a centralised state even after the regions were given more autonomy. This centralised state was maintained through controlled checks (carried out through informants and the secret police) on the activities of regional authorities to ensure state policy was carried out. More to the point, the way the state maintained its control was a good indication of the levels of distrust amongst the ruling elite about the activities of the lower social orders. For a fuller understanding of the issue of trust in Tsarist society it is necessary to examine the development of civil society.

Until the mid 18<sup>th</sup> century the state had managed to retain its strong hold on society. This was achieved through the social hierarchy it had created, its control over all property rights (including treating its citizens as property by restricting their freedom of movement and occupation), by using the secret police, and by encouraging members of society to inform on one another. Tsarist Russia's autocratic system, by using these methods of social control, could almost be said to have encouraged the vindictive frame-ups and unscrupulous business activities that often occurred (Baron, 1983). The state, to reduce internal insecurity, actively engendered a feeling of distrust amongst social groups and between members of the same social group, but this was at the expense of the development of civil society and economic development (Baron, 1983).

A nascent civil society did start to emerge as state control weakened in response to the expansion of the empire and with the reigns of some weak monarchs. Though it was only in the mid 19<sup>th</sup> century with reforms to local



government, the educational and judicial systems, that the autocratic rule of the Tsar lessened sufficiently for Russian citizens to gain more rights (Kochan and Keep, 1997). This allowed various voluntary associations to emerge such as charitable trusts, temperance societies, professional organisations, trade unions, joint stock companies, agricultural societies, Sunday schools, libraries and reading rooms. The secret police still operated but this did not prevent voluntary organisations being established. These organisations together with a gradual increase in the use of local markets by the bulk of the population must have increased the experience of non-kin based economic relationships and concomitantly helped improve trust levels. Trust levels are in a continual state of flux as they change in response to personal experience, but they must have improved significantly for the increase in small business activity that occurred during the late 19<sup>th</sup> century in the Don region and throughout Russia.

Increased (generalised interpersonal) trust from the 1860s also seems to explain why some forms of co-operation came to exist in Russia. The most well known form of co-operation, the obshchina, was in agriculture and harked back to a time before the peasantry was enserfed. It, like the other bottom up associations, was created to perform social tasks like road building (Timoshina, 2000). Often though there was some reluctance to get involved in social tasks, which indicates that not all forms of co-operation in Tsarist society would have contributed to improving trust levels.

The forms of co-operation that are likely to have had an advantageous effect on trust were consumer, credit and producer co-operatives. Co-operative banking was especially important for raising credit to finance small-scale industrial opportunities after 1861. These banks became more widespread by the beginning of the 20<sup>th</sup> century, indicating that the law was sufficiently strong enough to protect this



kind of bank lending. Moreover, increased levels of trust in society must have been developing for the many small-scale self-help co-operative banks to emerge, otherwise people would not have pooled their savings to provide loans. The development of such banks also indicates that there were profitable returns available from the newly emerging opportunities. Although many reforms in 1907 stimulated more self-help co-operative business activities (Nove, 1989), other developments in the market continued to undermine trust levels.

In the late 19<sup>th</sup> and early 20<sup>th</sup> centuries a more insidious form of co-operation became widespread. It took the form of cartels or syndicates created by large firms in a variety of sectors to help protect profit levels in a weak market where transaction costs were high (Crisp, 1976; Gatrell, 1986). Although this was more a feature of heavy industry<sup>43</sup>, it was also evident in the flour milling industry within the Don region (Sushchenko, 1997; Dyubenko et al, 1979). The existence of cartels, even in the Don's food industry, provide some indication that the market though expanding was still weak for some sectors, as large firms attempted to squeeze out their competition by price fixing, which did nothing to restore the already tarnished image of business. If anything this kind of business activity indicates that business ethics were non-existent, which should not be surprising when the imperial court itself operated in an environment where intrigue, corruption and jostling for power had been common.

Bureaucratic corruption developed in Tsarist Russia, largely as a result of the discretionary power bestowed on officials and their low wages. It frequently resulted in business owners competing with rivals to obtain bureaucratic favours such as licences. Bureaucratic decisions on licences or appeals then was not just simply dependent on fulfilling state regulations, but rather on whether a business was in a favoured sector and what the owner was prepared to pay (Kirchner, 1966). Moreover, bribery appears to have been accepted as long as it was covert (Baron,



1983), because not only did bureaucratic superiors also personally benefit, but it eased the administration of business (Shannin, 1986)<sup>44</sup>. For business the problem was that licences or other favours were distributed in an irrational manner, depending more on money than economic rationale. Business then was uncertain about obtaining licences, and more importantly corruption undermined such business objectives like profitability and efficiency, which ordinarily should have been guarantors of success. Bureaucratic corruption did not just harm business and industry, it damaged relationships between officials and business and also between officials and other members of society, who were well aware of the collusion that frequently existed between business and officials.

Encouraging distrust and condoning bribery did have a negative effect on the behaviour of social groups in that the state's arbitrary and unpredictable interference tended to urge the concealment of business activities and profits. This reduced revenue from taxation, which prevented the state from being able, had it wished, to provide other social goods that could have also benefited industry. Another negative effect of distrust was the behaviour it elicited between social groups. Merchants concealed their profitable activities from the state and did not exchange market information amongst themselves; nobles concealed serf enterprises from the state and the peasantry concealed just how profitable their serf industries were from their noble owners, who like the state were legally entitled to confiscate everything from them. The need to conceal stifled rather than facilitated the growth and modernisation of industry; and modernisation had been a principal aim of the state. This culture of secrecy and concealment<sup>45</sup> then prevented the spread of new modern business practices, technical innovations and the exchange of information (Rieber, 1982). This was because although members within social groups had to trust one another on the whole they remained highly mistrustful of outsiders. Experience had shown merchants could not rely on the law to force customers to pay up, this made



them suspicious and distrustful when entering any exchange. This level of distrust slowed down their adoption of promisory notes (Rieber, 1982) which then contributed to limiting the development of their businesses and restricted profitability (Rieber, 1982)<sup>46</sup>. Distrust in business then contributed to Russia being more economically underdeveloped than the West.

Up until the mid 19<sup>th</sup> century trust was limited to members within social groups. For example merchants were deceitful when dealing with customers, but could be honest with other merchant suppliers and creditors (Owen, 1983). Members in groups of Old Believers trusted each other, not because of their common religion, but because the networks of relationships they had built up were strengthened by their religious beliefs and because ostracism from the group could mean economic ruin (Owen, 1983). Around the time of emancipation the existence of voluntary associations helped to increase levels of trust in society. This facilitated the development of co-operation, self-help organisations and the formation of manufacturing firms in the consumer sector such as food-processing sector. Despite the growth in levels of trust Russia remained a 'low trust' society compared to other western nations right through to 1917. These low trust levels are important for understanding the nature of opportunities, constraints, risks and the level of transaction costs facing independent business in Tsarist Russia.

## 4.6 Conclusion

Small business existed throughout the Tsarist period and was evident in the Don region in the food-processing industry. The numbers of small firms in the Don region and throughout Tsarist Russia were influenced by a number of factors. Of particular importance according to the conceptual framework are:- the opportunity structure, level of risk and transaction costs. This conclusion also needs to take into account



that the impact of these factors on small firms differed before the watershed event of emancipation in 1861 to after.

Before 1861 industrial development in the Don region was slower than in other Russian regions, reflecting that it joined the Russian Empire relatively late and had to wait until the border moved further south. Nonetheless as elsewhere in Russia opportunities for all businesses, except large-scale firms in the defence sector supplying the state, were limited because the consumer market was weak, so most food production was for home consumption by a population that was largely self-sufficient. In the second half of the 19<sup>th</sup> century reforms to formal institutions, improvements in the transport infrastructure and the growth of towns strengthened the consumer market, which created opportunities for investment in such industries as food-processing. In the Don region in the second half of the 19<sup>th</sup> century food-processing (for example conserving) took advantage of new peasant farms that were diversifying agriculture (away from cereals) into cash crops such as fruit and vegetables. Not all food sectors in the Don region were able to take advantage of opportunities on the national consumer market some like meat and dairy remained local due to the lack of innovation in packaging and preservation. Although opportunities did open up after 1850, formal institutions and the activities of the state and its bureaucrats continued to stifle innovation by increasing the risk and uncertainty in the economic environment. This was especially so for any firm that was not patronised by the state or willing to pay bribes.

Opportunity seeking then did take place but it was suppressed by the way the state restricted property rights and also by social institutions which shaped the opportunity structure for each social group. Until judicial reform was carried out in the late 19<sup>th</sup> century there was limited protection from state interference and abuse in business. This chapter has shown how state control of property rights had a



negative impact on merchant businesses and how it dampened merchants opportunity seeking, which contributed to them being conservative in business. Opportunity seeking was also influenced by social group culture and this placed limitations on the way the nobility, merchants and the Don Cossacks engaged in business and industry. Even though institutional reforms in the second half of the 19<sup>th</sup> century opened up, the opportunity structure for all social groups, social group culture still had a negative impact on the propensity of many social groups to engage with opportunity seeking. For the peasants this was not as evident, they were the one social group that showed signs of reacting to market signals by developing peasant farms. Change to the opportunity structure though important was not the only factor impacting on opportunity seeking, risk was also influential.

In a weak market with limited legal protection conducting business was risky, but this was compounded by the actions of the Tsar and bureaucrats. Prior to the mid 19<sup>th</sup> century the various social groups had limited property rights, which the autocratic state exploited to control the development of industry and business to prevent undesirable social groups from becoming wealthy and powerful. Even after reforms to property rights, industry remained susceptible to unpredictable decisions by the state and its bureaucrats. Business survival, throughout the Tsarist period, had little to do with efficiency and profitability rather it was dependent on the whims of officials and rent seeking practices of local bureaucrats. Business also competed for state favours, but this only encouraged the use of underhand methods as rivals besmirched on another. Such practices and the poor reputation of business in Tsarist Russia, indicated that trust levels in society were low. Moreover it was to the state's advantage to foster distrust and business risk because this enabled the state to control non-state business and industrial development.



High levels of risk in general reduced opportunity seeking, but the level of risk faced by all the social groups differed. Outsider social groups not being inside the social system could not fall into a lower social group so consequently business failure was less of a risk than it was for insider social groups. For the nobility risk was a much less influential factor than the stigma attached to engaging in business and industry. The merchantry, the one group with access to market knowledge, was the most susceptible to risk, and remained cautious to protect wealth and social status. It could be argued that the least risk averse were estate peasants, but their ability to enter into business was dependent on their noble owners, they themselves lacked access to any factors of production. Risk then was relative, and dependent on social status.

Entering into business involved risk, which indicated that transaction costs were high too during the Tsarist period. The state designed formal institutions to protect its position and the country from invasion, so institutional change was never damaging to the state, which indicates that transaction costs never fell substantially. Market failure was responsible for high transaction costs, though before 1861 large state patronised industries were protected from them by the actions of the state, in other words through tariffs, consumption and in supplying inputs, labour and finance. All other businesses were unable to compete against this, they had to wait for transaction costs to fall in the second half of the 19<sup>th</sup> century and for improvements in demand levels and the expansion of rail.

The entrepreneurial spirit in Russia did exist, but it was thwarted from fully expressing itself by high transaction costs, a limited opportunity structure and high levels of risk. The next chapter will use the conceptual framework to examine the legacy of Tsarist formal and informal institutions inherited into the Soviet system. Although the Soviet system banned capitalist non-state business, its institutional



legacies need to be examined to understand the ramifications for small firm formation in the 1990s.

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## End Notes

<sup>1</sup> The name the Don region will be used throughout this chapter in accordance with the literature examining the Tsarist period, it was only in the 20<sup>th</sup> century that this region was re-named Rostov oblast. It should also be pointed out that the literature on this region makes reference to Donskaya oblast (the Don oblast) and oblast of the Donskogo voiska (oblast of the Don Forces), which in this chapter has often been termed as the Don region.

<sup>2</sup> Russian industry was characterised by a relatively large number of giant concerns employing over 1000 workers (Crisp, 1976).

<sup>3</sup> Gatrell comments that factory inspectors did not record cottage or urban handicraft industry (Gatrell, 1986).

<sup>4</sup> In the first half of the 19<sup>th</sup> century basic industrial goods including consumer goods were produced in small cottage industries (rather than large firms). The small-scale enterprises in the consumer industry produced 80% of the total volume of products produced in the 1850s. Large factories using division of labour only gradually developed in Russia (Timoshina, 2000).

<sup>5</sup> The factory inspectorate defined factories as having no fewer than 20 or 30 employees in 1913, so Russian official statistics understated or omitted the true number of small factories. Kustar industry was not statistically recorded at all; urban artisan industry (*remeslo*) was only recorded in large cities. Even in the 1890s 40% of all new firms had fewer than 50 people working in them (Crisp, 1976).

<sup>6</sup> As soon as Mongol occupation ended the Russian state engaged in strengthening its defence by for example building forts against raiders (Shanin, 1986).

<sup>7</sup> The domination of state industry in the Tsarist economy did progressively become less pronounced, so that by the second half of the 19th century it was private industry that dominated (Mckay, 1970).

<sup>8</sup> Russia only acquired some of the best stretches of black earth land in the 16th and 17th centuries (Crisp, 1976). The territory around Krivoi Rog was conquered by Russia from Turkey in 1733-74, and in 1739 so too were parts of the Donets basin (Baykov, 1954).

<sup>9</sup> War with Turkey, 1695-6 led to the capture of the area round Azov in the Don Region, and in 1711 led to the loss of the fortress in Azov. Finally in 1774 territorial gains moved the Russian border further south to the area near the Kuban river in the Caucasus (Heyman, 1993, Dzyubenko et al, 1979).

<sup>10</sup> After this date the waterways were also freed in the south, this provided links with countries of Europe via the Black Sea and the Mediterranean (Dzyubenko et al, 1979).

<sup>11</sup> Rail connected the Don region to Moscow (via Kharkov in 1871, and Rostov with Voronezh and Vladikavkaz in 1875 (Rostovskoe knizhnoe isdatel'stvo, 1957).

<sup>12</sup> The transportation of some important bulk products like coal and iron by boat from the Urals to Central Russia took six months if weather conditions were fair, otherwise two navigational seasons including over-wintering in Tver (Baykov, 1954).

<sup>13</sup> In the first half of the 19<sup>th</sup> century Russia remained a country that lacked a sufficient road system, the majority of existing roads were in a bad condition and in some seasons impassable. Only in the first half of the nineteenth century did they begin building surfaced roads and this was only between significant towns for example between St Petersburg and Moscow (Timoshina, 2000).

<sup>14</sup> Azov-Donskoi bank became a shareholder in the joint stock society called Russko-Donskoi coal. (Zolotov, 1974). The Petersburg International bank had interests in several metallurgical enterprises, for example 3 steam engine enterprises (Khor'kova, 1998). In 1912 out of 15 Banks in Rostov, 6 were commercial and had two thirds of the total credit turnover and they controlled all large industrial enterprises in the region (Roskovskoe knizhnoe isdatel'stvo, 1957).

<sup>15</sup> The banks became interested in other industries apart from rail in the 1890s (Sushchenko, 1997) and this was the start of their influence in Russia's industrialisation (Blackwell, 1994).

<sup>16</sup> This reference relates to the sixteenth century, though many historians argue that this remained the case for the bulk of the population right up to the 1920s. Shanin, (1986) for instance comments that in a Russian encyclopaedia published in 1913, the bulk of peasant households were described as consumer-labour enterprises with the consumption needs of the family as the main aim and the labour force of the family as their means. There was little or no use made of wage labour.

<sup>17</sup> Gatrell (1986) writes that in 1867 the urban population came to 10% of the total population or 6.67 mn, in 1897 it rose to 13% of the population (12.49 mn), in 1917 it increased to 25.84 mn and in 1916 the urban population was 21% of the total.

<sup>18</sup> By 1649 the state had defined societal groups. Each social group was subdivided into ranks each with their specific duties and obligations. Movement up and down the ranks within a social group was made easier or harder depending on the Tsar at the time, but movement between the 3 main social groups was difficult, though not always impossible (Rieber, 1982).

<sup>19</sup> Only the large distilleries on landowners' estates received state support. Most distilleries were small, sufficient for home consumption, because it was too costly for landowners to develop them (Blackwell, 1994).

<sup>20</sup> Noble industry and estate factories multiplied as a result of state protection; by the beginning of the 19<sup>th</sup> century they were commonplace (Sushchenko, 1997).

<sup>21</sup> Merchants were split into guilds, those in the **first guild** paid a tax of several hundred roubles for certification which allowed them to engage in foreign and domestic wholesale trade anywhere in Russia, retail trade in towns of residence and ownership of merchant ships, banks and large industrial enterprises.



Members of the **second guild** dominated domestic trade industrial, commercial activities were more restricted and members were allowed to engage in a limited amount of foreign trade, but could not become involved in banking or insurance.

Members of the **third guild**, with over 90% of merchants, were only allowed to engage in small-scale commerce and industry (Timoshina, 2000; Blackwell, 1968).

<sup>22</sup> At the same time merchants distrusted the state and would conceal its wealth in case the state seized it. They did not engage in long-term investments, because this would attract the attention of the state (Baron, 1983).

<sup>23</sup> Peter the Great wanted industry to produce equipment for the armed forces, however, because individuals with capital were reluctant to invest in industry he forced merchants to develop and take it over (in compensation he gave them loans and tariff protection). Merchants disliked industry at this time because profits were so low they could not compensate for the risk and expense that they incurred (Sushchenko, 1997; Gradov, 1997).

<sup>24</sup> Merchant social status was insecure in early 19<sup>th</sup> century. Loss of capital automatically could push them down to the third guild and even into the peasant social class, causing loss of privilege, which was not just a heavy penalty to pay but was a constant hazard in their line of work (Rieber, 1982).

<sup>25</sup> Merchants paid lower taxes. The system of service obligations merchants performed involved both fiscal (kazennye) and civil (grazhdankie) obligations which included being tax collectors, inspectors of manufactured goods and census takers (Rieber, 1982).

<sup>26</sup> Shanin defines peasants as small producers, who cultivate the land using simple equipment and the labour of their family to produce goods for their own consumption (Shanin, 1986). Gatrell writes that the term peasant was misleading, for in Tsarist Russia peasants often engaged in non-agricultural activities. Apart from activity on the farm and the production of handicrafts, some peasants worked in factories in their villages (Gatrell, 1986).

<sup>27</sup> The term serf tended to be used only for privately owned peasants, there were state peasants, church peasants and crown peasants (Gatrell, 1986). State peasants were generally better off than their serf counterparts.

<sup>28</sup> From 1736 peasants were required by law to obtain permission from estate owners to leave if they wanted to find temporary work elsewhere (Timoshina, 2000). They were also not allowed to buy land, set up a factory or hold a government contract (Heyman, 1993).

<sup>29</sup> Trade made up almost all the non-agricultural earnings of the peasantry in the 18<sup>th</sup> century (Blackwell, 1968). In 1812 peasants were allowed to engage in wholesale and retail trade, and also set up factories as long as they bought a licence (Gradov, 1997).

<sup>30</sup> State peasants had greater freedom, they were granted land plots for which they had to fulfil feudal obligations namely monetary obrok. This category of peasant from 1801 was allowed to acquire their own land, they were relatively free to choose from agricultural duties or artisan production, create small enterprises or live in towns (Timoshina, 2000).

<sup>31</sup> According to Volin, (1965) redemption taxes and other taxes exceeded income from the land, often because the land transferred to peasants tended to be of poor quality and in a poor location. Other historians such as Gershenkron (1965) maintain that the financial burden inflicted by emancipation was extremely high and increased poverty among the peasantry.

<sup>32</sup> Redistribution in the last decades of 19<sup>th</sup> century was coming to an end and in the north western provinces spontaneous enclosure of the common land took place creating many peasant farms. In Siberia, the commune was never important, and in the west and east the communal system was superseded by individual diversified farming with the raising of livestock, the development of craft industries and the growth of agricultural co-operatives (Treadgold, 1995). In 1905 the non-repartitional communes held 19% of peasants land, and in European Russia households had permanent possession of land (Shanin, 1986).

<sup>33</sup> Historians such as Crisp comment that the purchasing power of the peasantry did not fall after emancipation for redemption payments were lower than dues paid to landlord before 1861. Advantageously for peasants grain prices rose and rail allowed peasants to take the grain that would have previously rotted in the fields, to new markets. Crisp also writes that the ability of peasants to purchase land indicates that the payments burden could not have been greater following emancipation. Between 1883 to 1914 over 2 million peasants purchased land with the help of the peasant land bank, and this figure did not include those peasants who bought land by other means (Crisp, 1976). Crisp uses Ryndzunsky's work to provide evidence that peasants were purchasing or renting land in the first two decades after emancipation (Crisp, 1976). According to this evidence, although redemption payments were higher than the market value of the land, they were no higher and often lower than the average rents paid by serfs before 1861 (Crisp, 1976). According to Crisp the need for cash increased the marketing of agricultural products which in turn enabled peasants to buy land, and even estate factories. After emancipation the market grew for peasant crops (Falkus, 1972).

<sup>34</sup> Some peasants after 1861 transferred from trade to setting up their own manufacturing or industrial enterprises. They had developed many different skills as a result of their dealings with landowners and the state, and having to contend with limitations placed on them. As a result the peasant was generally very adaptable (Sushchenko, 1997).

<sup>35</sup> The Cossacks remained rural and did not live in towns or become involved with industry (Longworth, 1969).

<sup>36</sup> There were certain rules of behaviour. Children were not allowed to mix with other children outside the family, this though prevented social intercourse though it helped to keep the business safe. Merchants felt that trust in anyone other than the family was misplaced. Although in business merchants only trusted other merchants this was only up to a point, for example they often did not exchange business information amongst themselves. As a result, unlike the nobility and officials, they were less open and kept to the old ways of conducting business for much longer (Rieber, 1982).

<sup>37</sup> Experience taught merchants that customers did not always settle accounts, so they had little faith in an impersonal credit systems (such as promissory notes which were first made legal in 1729) and did not use them. Lack of trust meant that potentially more profitable new ways of conducting business were only very slowly adopted (Rieber, 1982).

<sup>38</sup> The peasant was slow to discard the sickle. There were good reasons for this; the new scythe was too efficient, it cut grain stalks too close leaving little straw to be gleaned, that could be used for fodder, roof thatch, or winter fuel (Donnorummo, 1987).



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<sup>39</sup> The merchantry constantly feared losing their financial security and status this fear kept social attitudes conservative and made them cautious in business (Rieber, 1982). They did not rebel against the state because their patriarchal attitudes to authority also prevented them from organizing against those in authority.

<sup>40</sup> Nobles entering trade were confronted by formidable disapproval from their class (Rieber, 1982).

<sup>41</sup> Merchants in the 3<sup>rd</sup> guild had a bad reputation for less than honest trading activities, unfortunately other merchants in the higher guilds, who were more honest, were also tarred with this bad reputation.

<sup>42</sup> Merchants were seen as exploiters, who paid other peoples' tax arrears to keep them dependent on them; in the eyes of nobility they were also bonded people because they paid the poll tax (Rieber, 1982).

<sup>43</sup> In the 1880s monopolies and the first cartels appeared in Russian industry, initially in heavy industry such as the steel sector and later in the food-processing sector for example in the wine and distilling industry, milling industry and sugar and salt industries. These cartels operated as monopolies. They often worked with the state for example in 1895 the Ministry of Finance and some sugar processors (*zavodchiki*) formed a society to protect prices (Timoshina, 2000).

<sup>44</sup> The higher ranks ignored the incidences of corruption amongst the lower official ranks, as long as it contributed to the smooth running of the department (Shanin, 1986).

<sup>45</sup> Secrecy ensured the success of business by preventing profits being taken by the state (Crisp, 1976).

<sup>46</sup> Examples include some merchants in Torzhok in the 1830s, who petitioned against the Moscow to St Petersburg rail-road even though they would have benefited. Some Volga grain merchants refused to use the rail road, and some merchants even refused veterinary assistance to fight anthrax, which was destroying their horses (Rieber, 1982).



## Chapter 5

# **The Soviet System and Non-State Small Firms with Particular Reference to the Food- Processing Sector**

### **Chapter Outline**

This chapter follows on from the Tsarist period to examine the formal and informal institutions in the Soviet system, in order to understand the impact of their legacies in the 1990s. What becomes apparent is that there are many parallels between the Tsarist and Soviet systems, though the Soviet administrative command system was a more extreme version. Briefly in the Soviet system independent economic activity was outlawed, the market was state controlled rather than free, property rights belonged solely to the state and the law and enforcement systems only existed to defend the interests of the state. In such a system it would appear that non-state owned firms could not exist, but they did in the informal economy and later as a result of legal changes in the formal economy as co-operatives. This indicates that Soviet Russia did not lack entrepreneurial initiative and experience. More important than examining the extent of entrepreneurial activity is an examination of the experience of independent economic activity to understand the behavioural traits that could be inherited into the post-Soviet period. In Soviet Russia this chapter has shown that the extensive non-state sector was supported by economic crime performed on such a large-scale, that only widespread bureaucratic corruption could facilitate and conceal it. Another issue that the post-Soviet state of the 1990s will need to address, was the inherited distrust of state institutions and bureaucrats, but also the implications arising from the kinds of trust based relationships that were built up in the informal economy. This chapter therefore, not only discusses inherited legacies but also shows the way Soviet institutions facilitated the existence of non-state economic activity.

## **5.1 Introduction**

This historical chapter examines the issue of non-state small firm formation within the Soviet period. Like chapter four to achieve this the conceptual framework is used to organise the academic secondary literature in both Russian and English to examine the influence of the polity, economy and society. The order in which these environments are discussed follows the pattern set in chapter four; it does not reflect the supremacy of one environment over another. First though it is necessary to clarify the aims of this chapter to understand why analysis of the Soviet period with its large state-owned enterprises would be beneficial for understanding small firm activity in the 1990s.



The abolition of all independent economic activity occurred in the late 1920s following the events of 1917 that led to the establishment of the Soviet administrative command economy. From then on, all manufacturing and business was undertaken in state-owned enterprises. Hence it would seem that analysing the Soviet period would be unimportant to the theme of this study. This though would mean ignoring the existence of the informal economy and the contribution of the co-operative sector in the official economy during the 1980s. An equally important reason for analysing the Soviet period is to understand the way its institutions have informed the experiences and behaviour of the Soviet people and subsequently the Russian people in the post-Soviet period. The transition years of the 1990s did not take place in a vacuum; the nascent market economy and the new institutions supporting it were imposed on top of the old Soviet administrative command system, which itself was imposed on top of the Tsarist system. Consequently one aim of this chapter is to establish the nature of the continuity between the Tsarist and the Soviet periods. The principal aim is an examination of the Soviet period to understand how the formal institutions enabled a non-state sector to develop. Moreover an examination of these Soviet legacies, that were then subsequently inherited into the nascent market economy of the 1990s, should provide greater analytical insight into the impact they had on the nature and extent of small firm formation in the post-Soviet period. First however, it is necessary to establish whether small firms existed in the Soviet period and the reasons why.

## **5.2 The Small Firm in the Soviet Period**

Manufacturing in the Soviet period was dominated by large state-owned enterprises. As with the Tsarist period, small firms were not seen as the epitome of modernisation. In Rostov oblast (formerly the Don region), as elsewhere in Russia, the large number of small firms inherited from the Tsarist period were planned out as



they were amalgamated to form large firms. Although large firms were the norm in the Soviet period this did not mean that small firms in the state sector did not exist. Small state-owned enterprises existed in accordance with Soviet location theory, determined by density of the population and the difficulties of transporting raw materials or manufactured goods to end users. They tended to be located in new towns, or areas where the population levels were low or where inputs could not be easily produced locally. This study though is not centrally concerned with the reasons for the existence of these smaller state-owned enterprises, nor about the way they operated. This study is interested in *non-state* small firms, whose existence is in response to the market and are the products of entrepreneurial behaviour. The only place where such non-state firms were found throughout most of the Soviet period was in the informal economy<sup>1</sup> and in the latter years within the formal economy in the co-operative sector.

Before analysing the existence of the informal sector it is probably more pertinent to understand the way co-operatives came into being in the official or formal economy. Although the informal sector was illegal, it was generally understood to be productive and was publicly recognised as such by the Soviet state in the mid 1980s. At that time the state wanted to harness and transfer this productivity into what had become a stagnating formal economy. The way it did this was to allow the formation of co-operatives that functioned on collective principles, but yet displayed some of the needed and valued characteristics found in capitalist firms that were also important for a socialist system. A co-operative then was a type of private firm that was formed at least partly on socialist principles, so that it did not compromise the fundamental ideology of Marxism-Leninism. This was one reason why they had been allowed to operate in other East European countries after the Second World War.



From 1985 the economy, through the co-operative sector, was supposed to be able to harness some of the more valued characteristics of capitalism such as innovation, initiative, profitability and improved productivity without compromising the fundamental ideology of Marxism-Leninism (Sushchenko, 1997). Moreover the development of co-operatives was ideologically sanctioned by an existing form of co-operative in the USSR known as the collective farm. The co-operatives of the 1980s though complicated the planning procedure, for they were outside administrative control, they were owned by the members of the co-operative and it was the co-operative that made the decisions on price and production (Adshead, 1992). Although incompatible with planning by 1989 they were providing 2-3% of all goods and services<sup>2</sup> in the USSR (Jones and Moskoff, 1989). The co-operatives sector then appears to have been successful but even this failed to persuade firms in the informal economy to convert into co-operatives and transfer into the official economy (Smith, 1992; Rutland, 1992; Sakwa, 1991). Consequently the co-operative experiment only partially fulfilled its aims. To understand why co-operatives were not a sufficient lure it is necessary to examine the continued appeal of the informal economy despite its surrounding hostile contextual conditions.

The informal economy<sup>3</sup> during the Soviet period existed because it addressed the needs caused by shortages of both consumer and producer goods that were prevalent in the formal economy (O'Hearn, 1980; Grossman, 1998; Sushchenko, 1997)<sup>4</sup>. As it was informal and outside the official economy statistics were not collected on it. It was only in the 1990s that Soviet research, looking into this sector from the late 1970s, was made available to some western researchers, but even now much about it still remains vague. What is known is that it had always been a part of the Soviet system, though it only became more widespread after Stalin's death in 1953, flourished from the 1970s and that manufacturing took place on both a small and large scale and in almost every sector<sup>5</sup> (Grossman, 1998).



Although the informal sector was an anathema to Marxist ideology it was only tolerated in the Soviet Union because it helped the state fulfil its socialist promise to provide the population with its basic needs (in return for retaining power). Another reason for its continued existence was that many top party officials were complicit in its existence (Grossman, 1998). Planners though had little real direct influence over it, except that the survival of informal enterprises was dependent on inputs stolen from the planned production of state-owned enterprises. In this way what it produced and the way it produced it was influenced by the plan, even if not directly controlled by it. The only other way the state attempted to control the informal enterprise was through policy that occasionally attempted to stamp them out. For example Khrushchev in the 1960s re-introduced the death penalty, but this campaign like many others did little to incapacitate enterprises in this sector because of the protection they received as a result of partnerships between leaders of the informal economy with representatives of the bureaucracy (Grossman, 1998; Frisby, 1998).

Whatever the size of enterprises in the informal economy they were, unlike state-owned enterprises, the products of entrepreneurship. Yet these enterprises were parasites living off state-owned enterprises in which they illegally manufactured goods alongside production for the formal economy. The most common products manufactured were in the consumer goods sector – clothing, footwear, household articles, knickknacks, recordings of music and so on (Grossman, 1977)<sup>6</sup>. Although academic articles have made no reference to processed food products acute shortages of them in the formal economy suggest that many would have been informally produced. One well-known example of an informally processed product in this sector is '*samogon*' or moonshine.

Non-state firms both large and small were present in the Soviet period in the informal economy and from the 1980s in the official economy. Their existence and



the way they operated were heavily influenced by the actions of the state and the ideology that guided it.

## 5.3 The Political Environment

As in the Tsarist period the state was a powerful centralised entity in Soviet Russia, that did not devolve political power to the regions such as Rostov oblast. This could have made the regional bureaucracy impotent, but as in the Tsarist period regional bureaucrats in applying national directives interpreted them in such a way that they had the chance to engage in rent seeking activities. Therefore the key to understanding the development of the co-operative sector, the informal economy and the role of the food industry is to analyse the way the state operated at both national and regional levels and the influence ideology had on policy and the actions of bureaucrats.

### 5.3.1 The Role of the State and Ideology in Soviet Russia

Soviet ideology was based on Marxist principals, which firstly adhered to the view that socialism was an inherently superior system<sup>7</sup> to capitalism. This is because under socialism the state takes over all the means of production, which it holds on behalf of the workers who are then free to work for themselves, whilst under capitalism a few wealthy capitalists exploit the majority (the working class). Furthermore it was believed that under capitalism working for oneself promoted individualism, selfishness and increased class differences and inequality, whilst socialism promoted egalitarianism, which would enable people to work harder not just for themselves but for the common good. Similar to capitalist countries there was a state responsible for the legislature, administration and judiciary, but unlike elsewhere the state co-ordinated the operations of all enterprises in an effort to



improve efficiency. Having such a powerful state was, according to this ideology, vital, but also because Russia, being the world's first socialist state, was surrounded by hostile capitalist states. This strong state would not only direct the development of the military industrial complex but all industry to effect socialism's superiority, in other words the state would bring about such economic growth that Russia would soon overtake the most developed countries in the West (Ward, 1994; Smith, 1992).

One important cornerstone of Soviet ideology was the need to modernise and develop industry. Capitalism created competition, which it was believed diverted attention away from production and prevented societies reaching their full potential. Socialist societies would eschew wasteful competition and would instead direct all their attention to the efficient development and deployment of technical advances. Reality though proved otherwise, and although modernisation was fairly successful in many of the defence industries, it had become obvious by the 1980s that the consumer sector industries had not advanced as much as they had in the West. It is well documented that the Soviet food-processing sector was unable to provide the kinds of quality products in satisfactory quantities that were taken for granted in the West such as low fat products, low calorie products, dried milk products, deep-frozen products and fast food products (OECD, 1991). The Soviet state had simply not been up to the task of taking over one of the market's important roles - stimulating innovation.

Soviet ideology was not that different from Tsarist ideology. Both supported a powerful centralised state, a powerful elite, development of the military industrial complex and the modernisation and development of industry in accordance with state wishes. Both were suspicious of allowing individuals to have free reign with entrepreneurial process, but it was the Soviet system that completely outlawed it. Non-state economic activity still, however, managed to take place, to understand why



and how the next section looks for answers from the way governance at national and local levels was carried out.

### 5.3.2 National and Local Governance

The strong powerful centralised state was inherited into the Soviet regime from the Tsarist system (Rutland, 1994), but the Tsar was replaced by the general secretary and later the president. The state in the Tsarist period was the chief administrative force and in the Soviet system it was the communist party's central committee, but whereas the state was previously not independent of the Tsar now it was not independent of the ruling communist party (Rutland, 1994). The communist party's policies were then disseminated down to ministries at both republican and regional levels for implementation, which again was similar to the Tsarist system. The only difference was that the Soviet bureaucratic system was a more extreme version being larger and more controlling than the Tsarist bureaucratic system (Strauss, 1969). Certainly Lenin's well-known phrase reinforces the idea that although Russia had undergone a major change to its system it nonetheless still resolutely remained the 'old Tsarist system only thinly anointed with Soviet holy oil' (Strauss, 1969)<sup>8</sup>.

Real power then in the Soviet system remained at the centre where decisions of national importance were taken. Consequently as in the Tsarist period local governance simply fulfilled an administrative role which gave it little real power. Power at the local level only really existed when collecting and disseminating information upwards to the centre and downwards to the enterprises (Strauss, 1969), or when interpreting central directives and using discretion in their implementation. Economic policy and the development of industry was nationally determined with local organs of power having little direct influence on their region's economic development.



### 5.3.3 Economic Policy

The communist party shaped the key economic institutions and all aspects of economic policy in the socialist system (Kornai, 1992). Although the Tsarist state had had considerable influence on the economy, at times determining the types of enterprises that developed and the products produced, its control was not as complete; moreover a free market type economy was emerging in the final years with both private and state enterprises. In the Soviet period the economy was totally subordinate to state control to ensure political policies and aims were fulfilled (Kornai, 1992). Private enterprise was outlawed, the state owned all enterprises and the state and not the market now planned all production and services, the construction of all new state-owned enterprises, the amalgamation of small firms<sup>9</sup> inherited from the Tsarist period and their demise.

One aim of the state in post-revolutionary Russia was to achieve economic growth quickly. It was to achieve this through large-scale industry and especially heavy industry, which was considered the main engine of economic growth (Kornai, 1992). As a result the Soviet Union evolved highly concentrated industries with a tendency towards gigantism (Campbell, 1991). Again as with the Tsarist period, industry in the consumer sector such as food-processing was understood as contributing less to economic growth and consequently was less important and received less support. This partly explains why it remained one of the few sectors to retain small and medium sized firms, another reason was due to Soviet location theory which took into account a variety of variables such as:- access to fuel, energy, raw materials, availability of labour and quality of transportation links (Campbell, 1991; Pukhal'skii, 1972; Govor and Schatkhan, 1983; Borisova, 1985)<sup>10</sup>. It was only large towns with a high density of population such as major consumer centres (for



example Leningrad and Moscow and other large cities in the regions such as Rostov on Don) that had large rather than small food-processing enterprises.

Economic policy did not just involve the establishment and demise of enterprises in the Soviet system it also involved the planning of production in all state-owned enterprises. Planning was a monumental bureaucratic co-ordination process that allocated all materials and semi- and finished products between enterprises and shops. In this the plan replaced the market, but as the experience of the Soviet Union illustrates planning was not a simple task of co-ordination. As in any economic system there were delays, losses and other frictions but state-owned enterprises were tied to the plan and were unable to look elsewhere for solutions to their difficulties, in other words the planning system lacked the kind of flexibility that is inherent in a market based system. The result was acute shortages in the economy, and it was this that provided the incentive for production in the informal economy, and in the 1980s for the co-operative sector.

The state's economic policy, which prohibited independent business, was supported by its law and enforcement system. As the plan designed and established enterprises as well as co-ordinated the distribution of an enterprise's goods it would seem that law and enforcement in the economic sphere would be less important than in a capitalist society. Certainly one of the main functions of business law was to resolve business disputes between state-owned enterprises, other than that there was limited use for such law. Business law then must have been less comprehensive than it was in capitalist countries and this may partly explain why it was so ineffective when dealing with the informal economy, though to understand this it is necessary to examine the role of the law in controlling all economic activity.



### 5.3.4 Law and Enforcement

Soviet law was designed by Stalin to strengthen the state's ability to govern and control economic activities. (Sushchenko, 1997; Humphrey, 2002). Some of its features were inherited from the Tsarist legal system, such as laws passed in secret without public consultation (Humphrey, 2002; Kornai, 1992) and state control of the legislature. Not only did the state control law making it also influenced court decisions, for the judiciary were obliged to concord with the party or official line in legal disputes; the effect was that court decisions were never impartial (Gustafson, 1999). The state moreover, could not be successfully challenged in court, and this protection enabled the bureaucracy, if not to infringe the law then to ignore and even interpret it loosely when it suited.

The consequence of having a judicial system that was partial to the state was that the public grew to distrust it, and tended to avoid it at all costs (Gustafson, 1999). As regards the business sector, Soviet law simply resolved disputes between state-owned firms, it was not prescriptive in the western sense of providing parameters for state-owned enterprises when transacting, and it outlawed non-state firms completely. Consequently there was no protection in law for any independent non-state economic activity in the formal or informal economy, and this includes any disputes that might occur in pursuing it or protecting benefits arising from it. The law simply protected the state's ownership of all property rights.

Under Soviet law full *property rights* belonged to the state held on behalf of the people which again was a legacy inherited from the Tsarist system. Unlike in the Tsarist system, property rights were never eventually extended to the elite in the bureaucracy all they had ownership over were their objects for personal use (Lowenhardt, 1995). In this they were in theory like the working class and the



peasantry which in this the system was understood to be egalitarian. All individuals, even those in the nomenklatura, to a certain extent lacked property rights over themselves. Everyone was required to carry a propiska or internal passport that placed certain restrictions over travelling and place of residence, they were required to work and could be directed into work by the state. It was only in the mid 1980s when some changes were made to property rights law that the co-operative sector was permitted to exist and had some incentive to develop.

Although co-operatives were now legal they still had to comply with legislation. The law for example determined which sectors<sup>11</sup> they were allowed to operate in; it also determined who could be employed in them and whether employees were allowed to work full- or part-time. By 1988 these legal restrictions had relaxed slightly encouraging an increase in the numbers of co-operatives. This is reflected in the increase of co-operatives from 8,000 in October 1987 to 14,100 on 1<sup>st</sup> of January 1988 and by January 1989 this figure rose again to 77,500 (Jones and Moskoff, 1989). Although legislation did change bureaucrats were used to interpreting the law, which meant they were able to implement it in ways that enabled them to extract economic rent. This left the new co-operative sector vulnerable to the demands of local officials who had the power to refuse registration and revoke permits when they liked (Jones and Moskoff, 1989; Ellman, 1989; Cox, 1990). Such an arbitrary and inconsistent application of laws and regulations were factors that inhibited informal enterprises from converting into co-operatives and transferring into the formal economy but also inhibited the development of the existing co-operative sector.

Although in the Soviet period there were laws to restrict private enterprise the fact that it managed to exist in the informal economy means that their effectiveness must be called into question. Bureaucrats and police were aware of what was



happening in the informal economy, but rather than applying the legal and enforcement processes they concealed this activity, only to use their power to extract economic rent from them (Grossman, 1998). The law then was not allowed to be effective, it was abused and ignored by state officials (for example the law on bribe taking promulgated on 20<sup>th</sup> February 1962), and this allowed space for some informal private enterprises to flourish. Another infringement of the law, that sometimes helped firms in the informal economy, that was also widely ignored by bureaucrats and management of state enterprises but for different reasons, was opportunistic stealing by employees (Grossman, 1977). Although there were punishments for this type of crime, it was so widespread that it was generally accepted by society as the means to compensate for shortages. Moreover, to a certain extent this form of economic crime was ignored to prevent the growth of social unrest that could potentially have threatened the continuation of the Soviet system.

Not all of the items stolen from state-firms were privately consumed much of it went into the underground economy that even eventually contributed in some way to the formal economy on building sites, or having been transformed into a vital input. From time to time the law was effective and arrests happened, but they mostly occurred for political reasons when there was a clamp down on the informal sector (O'Hearn, 1980). For example there were times that the local bureaucracy confiscated the produce of private plots to fulfil plan requirements. This was as much to avoid reprimands as a response to another state drive against unearned incomes (Hedlund, 1989)<sup>12</sup>.

This section on the state (regional and federal), legislation and economic policy has shown that the state, in designing institutions to comply with Marxist-Leninist ideology, had considerable influence on the way economic environment in the formal economy developed and the economic activity that took place within it.



Ideology though did not prevent the shortages that were inherent in the Soviet planned system. This created incentives that led to the establishment of the informal economy, and it was corrupt bureaucrats who weakened the operation of the formal enforcement system that enabled the informal sector to develop on the scale it did. The next section examines how the state sector operated and the ways in which non-state economic activity was shaped by the state sector. Examining how state-owned enterprises operated in the Soviet system and the institutions that supported them should also contribute to understanding the potential ways in which small firms in the 1990s remain affected by the previous economic system.

## **5.4 The Economic Environment**

During the Soviet period the development of industry in Rostov region was determined by the state. The state rather than the market controlled transaction costs by controlling access to factors of production and the development of the consumer market, all factors identified in the conceptual framework as important for influencing opportunity seeking and entrepreneurship. One issue that will be discussed first is the role of geography on the development of the food industry in Rostov oblast. Although the state was unable to influence the role of geography on industry, it still managed to manipulate it to ensure that its programmes and policies were fulfilled. This was very much in evidence in the way industry and in particular the food sector developed in Rostov oblast during the Soviet period.

### **5.4.1 Geography and the Transport Infrastructure**

The Soviet period saw a fundamental change to the economic structure of the Don region, which in 1937 was renamed Rostov oblast. This was because the economic environments of regional economies were developed in accordance with national



state plans and were less dependent on the location of natural resources, local culture or local initiatives. Consequently the state, in manipulating the development of industry, changed the industrial profile of Rostov oblast. From the very early years of the Soviet period many new industrial sectors such as mechanical engineering, hydroelectric power, the coal, chemical and metallurgy industries, which were deemed important by planners, were developed.

The state's influence on industry in Rostov region was even more noticeable after the Second World War. Occupation of regions like Rostov oblast had cut them off from the rest of the country and prevented them supplying important industrial inputs and food necessary to sustain the war effort. To avoid any future major disruption to the supply network the state developed a policy of autarky or self-sufficiency following the war. For Rostov region and the food industry this meant that the importance of agriculture in its economic profile was reduced and emphasis changed more emphatically in the direction of the heavy industrial sector (Dzyubenko et al, 1997). This did not mean that the food industry was no longer important, on the contrary it continued to receive investment, but to a lesser degree than other industries. The food industry in Rostov region was no longer as important as it had been during the Tsarist period, although it was still significant regionally, and nationally its share of industrial production fell in comparison with other industries despite growing year on year.

#### 5.4.2 The Development of the Food-Processing Industry in Rostov Oblast

Unlike during the Tsarist period, the Soviet period saw the introduction of completely new processing sectors and the growth in the size of food-processing firms through amalgamation to become large-scale enterprises producing thousands of tonnes of



food products (Pukhal'skii, 1972; Rostovskoe knizhnoe isdatel'stvo, 1957;<sup>13</sup> Davies, 1994; Dzyubenko et al, 1979). This process intensified after the Second World War when Soviet industrial location theory was introduced and implemented (Burgeinyi et al, 1979). Thus either in or around the outskirts of towns, such as Rostov-on-Don, with a large and growing population there were large food-processing enterprises.

Although Soviet location theory was applied to the region of the North Caucasus (Pukhal'skii, 1972) this did not necessarily mean that food-processing enterprises were equally distributed within all of its oblasts. For example Rostov oblast has 43 raions or districts (sometimes known as localities), and each had a dairy, but only 17 raions had a meat processing enterprise. This was because the location of enterprises was dependent on a variety of variables including the fragility of the product and the cost of transportation. Thus primary wine processing was located where the vines grew and secondary wine distillation was located near areas of consumption (Bondarenko, 1969). The result was that during the Soviet period these large-scale food-processing plants were located in areas where they were isolated from other food-processing plants. This meant that the advantages of agglomeration and untraded interdependencies that accrued in many regions of the West were not needed since the type of spatial clustering that encouraged them was not promoted by planners.

The way the food-processing sector developed in Rostov oblast during the Soviet era would have made it more difficult for small non-state firms, even if they had been legal, to develop in the formal economy. A planned economic environment lacks the spontaneous development of agglomerations and untraded interdependencies that small firms can draw on in market economies to help overcome deficiencies associated with their size. As a result the informal sector needed to be closely tied to



state-owned enterprises because this was the only way to ensure it had access to all factors of production as well as knowledge and expertise.

### 5.4.3 The Availability of the Factors of Production

The state through the plan controlled the distribution of all the factors of production amongst state-owned enterprises in the formal economy. State-owned enterprises did not in theory have to worry about finding land, labour, inputs, finance and even selling its products for the plan decided all these issues for them. This though did not mean that they did not experience problems with obtaining factors of production; mistakes in planning often left state-owned enterprises short. State-owned enterprises though had little option, as a result of their obligations to the plan, to obtain whatever factors of production they needed outside the plan. For this they employed a *tolkach* (an expediter or pusher an unofficial supply agent) who ‘nagged, begged, borrowed and bribed’ (Nove, 1986) his/her way through carefully cultivated network of contacts to obtain whatever was needed. In addition to the *tolkach* some managers of state-owned enterprises had close relationships with local officials from whom they also obtained assistance to access factors of production (and/or easier production plans). Unlike the *tolkach* type of relationship this was a form of mutual aid that enabled managers to get one another out of (but also into) difficult situations (Nove, 1986). State-owned enterprises then had two useful strategies for finding factors of production and consequently experienced far fewer problems than firms in the informal economy and in the co-operative sector.

Both the polity and the economy were officially hostile towards any independent economic activities. As a result, for manufacturing firms in the informal economy and also later in the official economy for the co-operative sector there were always difficulties in accessing the factors of production<sup>14</sup>. In the informal economy



all factors of production had to come from the official economy via corrupt officials or criminal groups. This involved cultivating contacts and networks and was reliant on verbal agreements, which was unlikely to have been without difficulty and may account for why manufacturing in the informal economy was less prevalent than trade and services (O'Hearn, 1980).

Many firms in the informal economy found it easier to obtain factors of production by manufacturing goods within a state-owned enterprise alongside (yet outside) production for the formal economy. In other words this was internalising informal working within a large state-owned enterprises. Conducting informal production in a state owned enterprise necessarily involved bribing managers, if they were not among the instigators, as well as local officials. The only access to finance was through friends and family and from the informal economy. Official banks in the Soviet Union only provided money (though not in the form of cash) to state-owned enterprises and to the public for such consumer durables as cars. In other words there was no long-term investment means available in the formal economy that could have been directed for use in the informal sector.

Even in the formal economy legally approved co-operatives still found problems accessing factors of production from the state supply system (gosnab), state-owned enterprises<sup>15</sup> or state banks<sup>16</sup> (Jones and Moskoff, 1989; Ellman, 1989; Adshead, 1992). By imposing high prices on and controlling access to legally obtained factors of production the local administration restricted the number of co-operatives and their activities and ensured the continued dominance of the state-owned sector (Sushchenko, 1997<sup>17</sup>; Jones and Moskoff, 1989). Moreover the local administration used this problem to persuade co-operatives to work with state enterprises, this forced them to operate with state controlled prices<sup>18</sup>, which practically made them a part of the state-owned sector. Difficulties in accessing



factors of production and other restrictions indicate the inability of the Soviet system and its institutions to adapt to these new legal forms. Even worse it undermined the incentive for many firms to leave the informal sector, one of the original intentions of state co-operative policy (Ellman, 1989; Smith, 1992). As a result many co-operatives only ever existed on paper (Cox, 1990). Those co-operatives that did flourish, were either connected in some way to the nomenklatura or were innovative in obtaining their factors of production, for example by transacting in the informal economy (Sushchenko, 1997).

The conceptual framework suggests that the ease or difficulty in accessing factors of production is just one facet that by increasing transaction costs influences small firm formation, another important element is the *opportunity* that exists in the consumer market, which itself is reliant on income levels.

#### 5.4.4 Wage levels and the Development of the Consumer Market

Wage levels were allocated by the state in accordance with work performed and levels of qualification, and represented in Soviet ideology a fair equivalent of an individual's contribution to society (Nove, 1986). There were strict limits on wages, so workers were also compensated with a variety of other benefits, such as housing rent, health and dental care, utilities, holidays and so on. This resulted in the major proportion of wages, for all workers, being available to spend on consumer products. Moreover the Soviet system was to supply just the correct amount of consumer goods that would correspond to the aggregate wage bill to clear the Soviet planners controlled consumer market. Unfortunately planners were unable to control consumer preferences as well as they could wages, and this resulted in shortages of



some products at the same time as there were plenty of others that were unwanted, consequently consumers often had a surplus of unspent income.

Consumption in the Soviet Union then did not so much depend on whether a person could afford to buy a particular product, but rather on whether that product could be found. The result was pent-up consumer demand that was waiting to be exploited. One way this demand was satisfied was through the farmers market (known in Russian as the *kolkhoz* market). This was the only place that was officially allowed to operate with free market prices, established by the forces of demand and supply, which also meant that unlike in the state controlled sector it did not suffer from supply shortages.

Apart from the *kolkhoz* market the only other place where pent-up consumer demand for goods and services could be met was in the informal sector. Despite political disapproval, legal constraints and economic barriers, acute shortages in the informal economy indicated that opportunities were evident (even though opportunity seeking was discouraged in Marxist-Leninist ideology as being exploitative). For opportunities to be exploited access was needed to the factors of production, and since there was no market to provide them, access had to come through the state enterprise sector using contacts or irregular means such as the informal market. Consequently opportunities could only be satisfied by those sections of society that had access to state controlled factors of production, and these were often the criminal sections of society or corrupt members of the bureaucracy such as state enterprise managers.

To sum up, the economic environment both formal and informal was hostile to small independent non-state enterprises in the Soviet period. Moreover the Soviet system was legally incapable of supporting any form of non-state activity until 1985



when the development of the co-operative sector was politically sanctioned. Shortages and unspent income provided the incentive for the informal economy and the establishment of non-state firms. As the market was not free access to factors of production for both these types of non-state firms was dependent on connections and it is this, which indicates that transaction costs must have played a role that at times may even have prevented production from taking place.

### 5.4.5 The Role of Transaction Costs in the Economic Environment

On the surface it would appear that in an economic system without a market and where property rights belonged to the state, that transaction costs would be non-existent. Certainly this was the case for the state-owned sector when the plan allocated all factors of production. As the plan often failed to work efficiently state-owned enterprises were forced to use a variety of methods to obtain the factors of production they needed and it was here they experienced transaction costs. These transaction costs represent the time, energy and uncertainty that using these extra-plan methods involved. Just as such exchanges may have involved difficulties, it was also in the interests of state-owned firms to help one another out and ease this process of exchange by reducing transaction costs. Although the state-owned sector had to do what it could to secure the factors of production it needed, transaction costs even if high did not threaten the survival of the enterprise, and this was even when production may not have taken place in the quantity determined by the plan. This experience though was not the same for those non-state firms that were the products of the entrepreneurial process.

The co-operative sector's experience of transaction costs was completely different to the state sector. Being external to the plan co-operatives had to



overcome administrative obstacles so that they could legally use the state supply system to obtain premises from the state sector or finance from the bank sector. The co-operative sector had to spend much time and effort, as a result of its limited property rights, when entering into any form of legal exchange with the state sector. The state sector for its part was reluctant as a result of planning inefficiencies to release any of its factors of production. This and not always being able to depend on the law to protect any contracts it had with state-owned firms caused significant difficulties. As a consequence the co-operative sector never experienced zero transaction costs and the difficulties they had with the authorities during registration and obtaining factors of production explains why many co-operatives only ever existed on paper. Those co-operatives that survived were most likely reliant to some degree on influential contacts in the nomenklatura and the informal economy, which must have reduced transaction costs substantially.

One might have considered that it would be in the informal economy where transaction costs would have been prohibitively high. The fact that the informal economy was so sophisticated and so extensive (Grossman, 1998) indicates that ironically this could not have been the case. Corruption amongst the bureaucracy was so widespread (Nove, 1986), and the connections between representatives of the administration and members of the informal economy so extensive, that there was sufficient access to factors of production but also mutual protection for those involved. Those that were involved in this adhered to a strict code of behaviour in other words they had their own informal institutions based on verbal contracts that provided protection and kept transaction costs sufficiently under control to encourage exchange and production to take place (Frisby, 1998). Consequently transaction costs must have been sufficiently low enough to enable the growth of the informal economy in the 1970s and 1980s (Grossman, 1998).



Transaction costs and the formal and informal economic environments were not the only influential factors. The next section examines the impact of the socio-cultural environment, starting with social groups but then going on to discuss the influence of informal institutions such as trust and attitudes to non-state economic activity to understand how they affected its development.

## **5.5 The Socio-Cultural Environment**

The socio-cultural environment underwent a radical change as a result of the revolution in 1917. The Tsar, nobility and merchants were social classes that no longer existed in the new Soviet Russia. Although the new social groups were ideologically understood as not being classes, they were as in the Tsarist period still engineered by the state. The state also tried to influence the public's response to non-state economic activity and to some extent they succeeded in creating a culture of distrust. Yet this distrust did not stop the public from engaging with the non-state sector and this enabled it to grow. So although the public was portrayed as hostile towards it and the idea that here there were speculators, it still nonetheless used it to obtain consumer goods and services. Before examining in more detail the different informal institutions highlighted in the conceptual framework it is necessary first to examine the social groupings from which potential founders of informal businesses and co-operatives would come.

### **5.5.1 Social Groups**

Soviet society was not socially unstructured; however the social groups that came to exist were different to the Tsarist class system. Ostensibly Soviet Russia was a classless society with the working class being ruled by themselves, or more precisely by their representatives, moreover in this society there were no outsiders (except



dissidents). What existed was grouping by employment, with some of the working class being chosen to join the exclusive nomenklatura through which they obtained positions of authority that gave them access to certain privileges. In other words the nomenklatura was a form of incentive system for a socialist economy. The jobs in the nomenklatura system were not all equal, they were ranked in order of importance like enterprises were, and this determined the level of remuneration, perks and privileges that were available to each individual member. These privileges though were never secure because just as in the Tsarist system demotion was always possible (Ward 1994) so officials who fell out of favour could lose almost everything (Steele, 1995).

As a result although the bureaucratic elite had access to many privileges they would have been careful to retain their positions and this might have influenced their involvement in the informal economy. Certainly in the Stalinist era and especially during the years of the reign of terror bureaucratic conservatism may have limited involvement in the informal economy. By the Brezhnev era, however, although the threat of imprisonment still existed there was less fear so bureaucratic involvement in economic crime in the informal economy increased. In this members of the nomenklatura took a risk, or at least a personal risk, the commercial risk was far smaller because they could easily commandeer the factors of production from the state sector. Moreover in the 1980s they had the opportunities, means and contacts to set up and operate successful co-operatives.

The next two social groups that could have been potential sources for a supply of entrepreneurs in the informal economy and later in the co-operative sector were the working class and the peasantry. As in the Tsarist period the peasantry in Soviet society was the least respected group, and rural areas suffered from having fewer amenities such as shops and had to contend with both poorer quality housing



and transport infrastructure. To a certain extent, this may have provided the peasantry with the motivation and opportunities to engage in some officially tolerated private business through the legal use of their household plots. As the state's food supply to rural areas was so poor peasants were encouraged to produce their own food, and as there were shortages in the towns, to produce a surplus for sale there too. Consequently this social group had the potential to engage in small-scale production. Unfortunately any opportunities to develop these plots into small farms was restricted by the small size of land officially allocated to them, consequently most of the food produced was consumed, and it appears that adding value through processing was virtually non-existent. It was not just the small size of the household plot that reduced opportunities for peasants; it was restrictions placed on their travel by not having an internal passport that prevented them from supplying any other kolkhoz market apart from the local ones. The peasant social group therefore only had some limited opportunities for enterprise, unless of course they operated in the informal economy. There is however, no way to assess the extent to which peasants were involved in the informal economy, though Wegren has written extensively about rural workers, who were able to specialise in certain crops (Hedlund, 1989; Wegren, 1998a,b).

The final social group, which contained the majority of Russians, was the working class group. It is the members from this group who were likely to have had the skills to exploit those opportunities that existed in the non-state sector including co-operatives, though unlike managers and bureaucrats they would have had problems accessing the factors of production. Certainly the growth in the numbers of working class that developed skills as a result of improved access to education coincided with the years when the state was less Stalinist, from the 1970s onwards, and when the informal economy started to flourish (Lowenhardt, 1995). Even so involvement in the informal economy especially for manufacturing would have been



dependent on support from officials such as managers and bureaucrats. As for setting up co-operatives they may have had greater difficulty in accessing sufficient quantities of factors of production than managers because they lacked contacts with bureaucrats and *tolkachi*. These problems though did not mean that they did not actively seek opportunities.

All social groups had some experience of the informal economy either as consumers at the *kolkhoz* market or by using the services of moonlighters such as electricians, teachers and so on. Those who actually set up enterprises in the co-operative and informal sector could have come from any social group, however it was easier for party officials/bureaucrats or members of the working classes to exploit opportunities. The working class because they had the skills and access through work to many factors of production, and managers or other members of the *nomenklatura* because they could gain access to large amounts of all factors of production.

Taking part in the informal sector and later the co-operative sector was not just dependent on skills and access to factors of production but also on cultural factors such as attitudes and trust levels that influenced if not directed this kind of entrepreneurial behaviour.

### 5.5.2 The Cultural Environment and its Influence on Business Activity

The Soviet period lasted over 70 years giving it some seven decades to shape the values and behavioural patterns of the Soviet people (Lowenhardt, 1995). The Soviet system was legitimised by a code of moral imperatives that were reinforced by official statements, rewards or privileges and penalties, by literature and even



officially approved works of art (Kornai, 1992). This kind of propaganda was widely distributed and with the experiences of the years of terror in the 1930s instilled a fear of harsh punishments as a way of securing the compliance of the population. Obedience and discipline were also achieved through rewards like membership of the nomenklatura system, but this discouraged individuality in the formal economy and gave the appearance that in Soviet Russia there was no experience of entrepreneurship and the entrepreneurial process.

Some forms of entrepreneurship was not always discouraged, for example moonlighting which involved providing necessary services at modest prices in an individual's own time and some private craft trades (Nove, 1986). Any other form of non-state economic activity (including even peasants at the kolkhoz markets) was despite being tolerated still culturally associated with speculation and exploitation. Cultural incentives for engaging in non-state economic activity were then largely missing in the Soviet Union. Although cultural disincentives were evident, the continued existence and widespread use of the informal economy and the kolkhoz market suggests that there must have been some cultural acceptance of them.

There was a double attitude to the informal economy and non-state business whether co-operatives or the informal sector. On the one hand it was for a large part officially tolerated because it helped with reducing shortages of consumer goods and services. On the other hand surveys of public opinion indicated that the majority of the population resented having to use them. In particular the public was hostile to the high prices on these 'free markets' (Sushchenko, 1997) and the high incomes that so called 'speculators' obtained from undertaking these activities. The presence of non-state economic activity may also have given the impression that the state was weak and not doing enough to protect the public from such speculators by guaranteeing fair prices. To address this the state from time to time restricted the



operation of co-operatives and household plots and prevented food products from being sent to kolkhoz markets (Hedlund, 1989<sup>19</sup>). These clamp-downs though often missed the grander forms of economic crime such as informal production within state-owned enterprises. This allowed bureaucrats in authority to give the impression that they were enforcing the law against speculation without affecting their own form of informal wealth creation<sup>20</sup>.

Soviet cultural norms and ideals did not appear to be conducive to the development of a non-state sector as hostility towards private business activity and its rewards were embedded in both official ideology and public opinion. This cultural distrust and hostility towards non-state economic activity was fed by bureaucratic propaganda and this may have been used to keep the numbers involved in it and the co-operative sector low. It was not just social attitudes, which were negative towards non-state economic activity; distrust also played a role.

### 5.5.3 Trust in Business and Society: A Key Factor

The Tsarist system in its latter years had developed into society where trust in business was being established, and it was facilitated by the beginnings of a nascent civil society. The Soviet Union on the other hand developed into a typical low trust society, where a centralised state maintained its power through fear, reinforced by its use of informers and the secret police. It was also the underdevelopment of civil society and the widespread existence of corruption amongst officials that provided an indication that the levels of (generalised interpersonal) trust in society was low.

The Soviet state at its inception instilled the idea that as the system was new and radical there was a danger of attack from their capitalist neighbours, who did not understand or accept its fundamental Marxist-Leninist principles. Consequently the



public were warned to be vigilant for both internal and external foes, and to inform on them. This created a culture of denunciation, where vengeful employees informed on bosses; neighbours turned against neighbours and members of families informed on one another. Fear of denunciation, the labour camps and even potential execution entered into the psyche of the population and was used as a means of social repression as well as a way to obtain discipline and obedience to the party (Kornai, 1992). In this way the state attempted to discourage and even wipe out initiative, and to prevent capitalist forms of business from establishing.

Fear of the state was just one factor that created a low trust society another was the inability of the state to fulfil its side of the socialist promise. In other words by the 1970s the Russian people were beginning to find it difficult to continue believing in the promise of a better life just around the corner (Kornai, 1992). Granted they received subsidised foodstuffs, rent, books, theatre tickets and free health services and education as promised, but the quality tended to be poor or was plagued by shortages, so the improvements in living standards that had been eagerly awaited since 1917 were simply not being achieved. There was, however not just distrust of state promises and management of the economy, there was also (generalised interpersonal) distrust amongst members of society, partly because of the absence of (bottom up forces being allowed to create) a civil society.

In Soviet Russia all social organisations were controlled by the party with the effect that no group could exist, unless it was established by the state. Consequently civil society in the western sense of the term was missing, which meant there was limited opportunity to learn the habit of trust culturally through voluntary association and social co-operation. People could join collectives at work or outside, but these were organisations that had been set up by the authorities, so although people were free to join and interact, there was always a certain reticence over whom to trust.



Moreover each person knew that to get the most out of the Soviet way of life they needed to show their obedience. Consequently they cultivated the right types of contacts in these organisations to conform to party expectations, but this was not the same as informal trust based relationships that develop spontaneously in the western conceptualisation of civil society. So although outwardly there was the impression that Soviet society was based on the collective and valued co-operation, distrust and suspicion created a different reality, with Soviet Russia being more of an individualistic society, with people paying lip service to the collective organisations they belonged to.

Much of the distrust that existed in Soviet Russia originated from the lack of trust the state had in its people. This resulted in the creation of formal institutions that were too restrictive and penalties that were too harsh, so rather than encouraging the Russian people to work for the common good they encouraged infringements such as concealment. Thus bureaucrats concealed information about the effectiveness of their enterprises to fulfil the plan, either to gain easier plans, to prevent knowledge of non-fulfilment becoming known or to take private advantage of overproduction. Managers concealed informal activities undertaken using enterprise inputs, equipment and labour. Workers concealed petty theft from work places and peasants hid the produce they obtained from their plots of land or transported them to farmers markets using covert methods. How extensive and successful concealment at all levels was, is not precisely known (Laird and Laird, 1983), but it facilitated the development of the informal sector. What is known is that concealment benefited individuals rather than the state, and although the planners knew about it and tried to compensate for it, false information meant they were never sure of the extent it affected planned production. Ironically then state institutions did not effectively protect state interests, but by being so restrictive and harsh encouraged



infringements of the law whilst also giving the impression that the people were conforming to every demand of the state.

Although Soviet Russia was a classic low trust society, for non-state firms in the informal economy the situation was different, they could not have existed without developing some form of trust based relationship. It was the nature of this trust here that needs to be examined. The informal economy could only exist as a result of economic crime, in other words as a result of stealing from the state sector. All those involved within it, were in effect partners in crime and they adhered to a strict code of behaviour that was based on a form of trust that provided mutual protection for such secret societies (Frisby, 1998). This then was the informal enforcement system that protected verbal contracts. Moreover from the 1960s and 1970s criminal groups released from labour camps gradually became more involved in the growing informal economy. These criminal groups formed partnerships with leaders in the informal economy and added their own criminal codes of conduct to already existing informal institutions, including the use of violence and intimidation. The increased association of the informal economy with violent criminal mafiya type groups did not appear to hinder its development. The problem was that this informal sector was not used to observing any kinds of regulations and its business codes of conduct or ethics incorporated threats of violence and intimidation that were not understood as acceptable business norms for transactions in mature capitalist economies.

Trust is a learned habit, but in the Soviet period there was not that much opportunity to learn to trust, most experience was learning to distrust. Distrust of the state happened for four main reasons, firstly the state did not deliver what it had promised. Secondly there was no protection for individuals from state actions by law. Thirdly the state made use of informers to obtain obedience and discipline from the Russian people. Fourthly state officials were distrusted because of their involvement



with corruption and their connection with the informal economy and profitable non-state economic activity. The state also promoted distrust amongst the people through its propaganda, which warned against the enemy from within. In addition the Soviet moral code reinforced a culture of distrust and hostility towards any form of non-state economic activity. The only kinds of trust based relationships that developed were based on concealment for mutual protection from the state. State-owned enterprises and *tolkchi* could just as easily help each other out as help each other into difficult situations. Individuals in the informal economy were connected through their economic crime and transactions here were enforced through strict code of behaviour reinforced by threats of violence and intimidation.

## **5.6 The Soviet Era and the Independent Small Firm: The Role of Risk, Opportunity Structure and Transaction Costs**

The Soviet administrative command system was not conducive to non-state economic activity in the formal economy :- it was outlawed, the state planning system only supplied factors of production to the state sector so socio-culturally it was interpreted as speculation and exploitation. Moreover as the state provided cradle to the grave care for its citizens in return for obedience and discipline, the impression was that in a Soviet state there was no need for individuals to engage with the entrepreneurial process to establish non-state independent firms. The fact that the informal economy existed and later that the state allowed the development of the co-operative, a form of private business, suggests there was both a need and opportunities to express entrepreneurship. One way to understand what affected the nature and extent of both the informal and co-operative sector is to examine transaction costs, the opportunity structure and the effects of risk, both personal and financial.



The establishing of an independent manufacturing firm in the informal sector would normally be associated with a certain amount of personal risk in any nation state, where there were informers and the secret police. The extent of shortages in the formal economy and the need to quell any potential source of unrest allowed the state to ignore its existence, which reduced the personal risk for those involved. From the 1970s leaders in the informal economy developed connections with corrupt representatives of the administration, which also provided a certain amount of personal protection. Even the existence of prison camps and loss of position were not sufficient disincentives. Personal risk may have been sufficiently low enough that lowering it even more by transferring into the co-operative sector in the 1980s was simply not a big enough enticement for those entrepreneurs in the informal economy. Financial risk was also minimal during the Soviet period, firstly because the factors of production were stolen from the state sector and secondly because in a system with cradle to grave social support, work or state benefits were guaranteed to be available. If personal and financial risk were of limited influence on the non-state sector then perhaps the opportunity structure shaped the nature and extent of its activities.

Shortages were universal in the Soviet economy and this provided opportunities for a non-state sector to exploit, but exploiting these opportunities is dependent on the opportunity structure. The opportunity structure is formed from having easy access to factors of production and having the right kind of formal institutions that do not restrict investment. This chapter has shown that informal manufacturing of consumer goods often took place in state enterprises alongside production for the formal economy. This provided fairly easy access to the factors of production, though what and how it produced was shaped to a certain extent by the enterprise's plan. The co-operative sector's opportunity structure was more limited because of the problems it had when accessing the factors of production. Moreover,



unlike the informal sector where the decision to invest in production was not directly affected by formal institutions regulating it, the co-operative sector's investment was. For example it was limited to certain sectors, it had to abide by registration rules, and had to deal with the arbitrary interpretation of legislation by local bureaucrats in the administration. The opportunity structure facing non-state firms in the informal sector was not shaped by any kind of restrictions, and this encouraged investment in it, which enabled it to grow and to exist in every economic sector. For the co-operative sector though there were many formal restrictions that limited the numbers of co-operatives and determined which economic sectors they could exist in. The attractiveness of the opportunity structure alone does not though determine whether opportunities were taken up, this was more dependent on the nature of transaction costs.

Transaction costs were high for any form of business other than a state enterprise because all property rights belonged to the state, the market was planned rather than free and the legal and enforcement systems were state controlled. The co-operative sector probably faced the highest transaction costs, because of the obstacles they had to overcome when dealing with bureaucrats and state enterprises, whether this was in registering or accessing the factors of production. These high transaction costs not only would have prevented the production of goods and services from taking place, but also contributed to many co-operatives existing only on paper. Many of the co-operatives that were able to operate were those that reduced their transaction costs by operating at least partially in the informal economy. The informal economy experienced lower transaction costs, because of its connections with crime and corrupt representatives of the administration, which eased access to factors of production, (though not as much as they would have done for the state sector). Also being illegal and in the informal economy these informal sector firms did not have to go through such bureaucratic hurdles as registration or



follow any legal requirements. Transaction costs then were more keenly felt by the co-operative sector than by the informal sector and this explains why few entrepreneurs in the informal sector in the 1980s used the opportunity to transfer into the co-operative sector as the administration had initially hoped would happen. When transaction costs combine with risk and the opportunity structure it is easy to understand why the informal sector remained more attractive in the Soviet period, despite its hostile contextual conditions.

## 5.7 Conclusion

Both chapters four and five have shown the continuity (as well as dissimilarities) between the Tsarist and Soviet periods in the political, economic and socio-cultural environments. Figure 5.1 presents a summary of these two chapters divided under the main concepts and factors in the conceptual framework, as developed in chapter three. Under each of the ‘environment’ subheadings are the key concepts which have been deemed as important in influencing non-state small firm formation. The table has been split into the two broad historical time frames of the Tsarist and Soviet periods, under each there is a brief description of the main characteristics for all the concepts examined in this study. This table shows that the formal and informal institutions changed only gradually, and in a path dependent manner, even following the 1917 revolution. Such similarities between the two historic periods confirms the need to understand institutions historically and to appreciate that their legacies may be shaping the way institutions operate in the post-Soviet period in the 1990s (the subject of chapter six). Consequently if past formal institutions, (which failed to reduce transaction costs sufficiently to encourage small firm formations) are inherited into the 1990s then one would suppose that similar disincentives in the formal economy will have a comparable outcome. This concluding section will summarise the most important factors that have been identified, illustrating the path dependent



manner in which institutions evolved in Russia and how they affected transaction costs by examining the influence of the political, economic and socio-cultural environments on small firm formation.

The political environment in both the Tsarist and Soviet period was shaped by a state ideology that was similar in both periods. It emphasised modernisation through militarisation in which the state needed to play a dominating role. The one important difference in state ideology between these two periods was the attitude to private firms and the market. In the Soviet period the institutions that would support a market economy were eliminated and the state took over the role of the entrepreneur, establishing new firms and developing new products. In the Tsarist period, although the state did control the economy and many of the firms that were established, this was not as exclusive or as extensive. This was evident in the role that private capital played even with strong state direction. Moreover, changes to the formal institutions in the late Tsarist period created greater space for small private firms, and this was reflected in the experience of the Don region, where there was a sharp rise in numbers of food processing firms.

State ideology was also reflected in state policies, which directed the way the economy and industry evolved. This chapter has demonstrated the importance the state attached in both the Tsarist and Soviet periods to the protection of large firms. In the Tsarist period this was through tariffs and taxes and in the Soviet period by state plans. State policy in both the Tsarist and Soviet periods tended to view independent small firms as a necessary inconvenience. Consequently the state never attempted to reduce transaction costs for them in the formal economy as they struggled to survive and operate within the parameters set by institutions that favoured larger firms.



Figure 5.1 Summary of the Key Features of the Tsarist and Soviet Periods Affecting Small Firm Formation

	Tsarist Period	Soviet Period
Political Environment		
Ideology	Ambiguous attitude to development of market economy; desire for modernisation but limited change to levels of control in society as well as to formal institutions	Hostility to markets and private enterprises, modernisation obtained through state planning, total state control of society.
Key Formal Institutions	State control and direction in developing the economy reflected in policies Limited property rights, rule of law poorly developed, and partial to state. Few limits on state power	Planned control of the economy, property rights belonged to the state, non-state economic activity outlawed. Law subordinate to the state – economic crime tolerated, because it rectified plan mistakes. Few limits on state power.
Key Policies	State took direct interest in development of industry – but not always to advantage of industry concerned. Regions principally administrative units subordinate to nation state.High priority of the military and industries supporting it. Tariff policy helped to create and protect industrial monopolies, restricting competition and innovation. Consumer sector of low importance. Taxation levels high for some social groups (a form of social control to prevent social climbing).	Regions principally administrative units subordinate to nation state. High priority of the military industrial complex. State created large monopolistic enterprises. Competition outlawed, innovation undertaken by state planning committee. Consumer sector of low importance.
Local Bureaucracy	Many bureaucratic hurdles for new small firms	In the late Soviet period overburdensome bureaucracy on the co-operative sector, which was the closest at this time to an independent small firm sector.
Economic Environment		
Spatial Integration	Rostov region – late regional specialisation in agriculture and food processing. Many non-state small food-processing firms, low levels of competition because of poor transport. Large market that opened up once transport infrastructure improved in late Tsarist period	Rostov region – decreased specialisation and increased autarky, development of wide industrial base. Food processing state controlled and organised on large scale, small plants only in exceptional circumstances. No spatial clustering. Competition non-existent in formal economy.
Factors of Production	Difficult to obtain until end of Tsarist period – mostly owned by the Tsar	Unavailable in the formal economy, available for non state sector in the informal economy.
Consumer Market	Slow development of consumer market as result of low levels of urbanisation and high levels of self sufficiency, Urban markets important at end of Tsarist period	Consumer market state controlled, unrealised demand leading to self-sufficiency, use of farmers markets and the informal consumer sector.
Risk	High throughout the Tsarist period. Lack of social safety net, low levels of demand, arbitrary behaviour of state, which could confiscate property or move individuals to other regions. High financial and personal risk	Personal and financial risk had little influence on the development of the informal economy or the co-operative sector, informal sector protected by informal institutions. State provides cradle to grave services for all citizens.
Transaction Costs	High for small firms and was expressed in the low demand for entrepreneurship throughout this period, except towards the beginning of the 20 <sup>th</sup> century. Opportunity structure very limited. State kept transaction costs high, prevented some social groups from taking part in it, poor legal protection.	Higher for small firms in the co-operative and informal sectors. Lower for state-owned enterprises, which were able to internalise some costs, but which also minimised costs because of state support. Demand for entrepreneurship in the official economy could not be satisfied by non-state economic activity. Demand for entrepreneurship in the informal economy was high. State kept transaction costs high and made the opportunity structure more restrictive for the co-operative sector. Transaction costs were lower and the opportunity structure favourable to the informal sector.
Socio-Cultural System		
Sources of Entrepreneurship	Business confined to certain defined social groups. Each social group had own cultural norms which often prevented taking up new opportunities	Entrepreneurship legally proscribed through much of the Soviet period, except during the 1980s when it was controlled through regulations on co-operatives, this form of entrepreneurship was then open to all social groups.
Attitudes to non-state business	Business not largely respected, high social risk with failure (in other words possible loss of status)	General hostility to non-state business, years of Soviet indoctrination led to widespread belief that it was a form of exploitation, speculation.
Trust	Low trust society arose through experience of annual fairs to obtain consumer goods where consumer not protected by law, also arose through arbitrary bureaucratic use of power, bureaucratic corruption (fuelled by low wages and official discretion in applying policy), development of secret police, unreliable legal system, poor level of business ethics, a social system that created class divisions between social groups that were largely hostile to one another, slow development of civil society, legacy of concealment	Low trust society, order maintained by fear and corruption, secret police, a legal system that favoured the state, lack of civil society (most social groups top down creations), legacy of concealment. Trust in the informal sector was a form of mutual protection for business partners who were undertaking a form of economic crime..



Formal institutions in both the Tsarist and Soviet periods reflect the evolution of their development along a path dependent trajectory. Fully protected property rights for example have never really existed in Russia and this seems to be one reason for why opportunities in the Tsarist period were slow to be exploited, given the uncertainty of ownership of assets and risks of confiscation. Furthermore any changes to state policy or institutions in both the Tsarist and Soviet periods that changed property rights to encourage non-state economic activity were hindered by local bureaucratic red tape which contributed to making transaction costs prohibitively high. Registering and obtaining licences for example was costly and time consuming process in the Tsarist period and for co-operatives in the Soviet period, largely because of the discretion given to local bureaucrats implementing state policy. To reduce state interference and transaction costs businesses have historically concealed information from the state and ignored formal institutions whilst appearing to conform.

It was not just institutional obstacles created by the political environment, but the hostile economic environment the state created that faced non-state small firms in both historical periods. Geography and the slow development and application of technology created difficulties that prevented raw materials from being fully exploited and markets from developing. In the Soviet period technical advances enabled the state to manipulate geography to create a regional industrial structure based on autarky and large state-owned enterprises, which transacted only in accordance with the plan. Economic policy in the Tsarist period did not restrict clustering of firms; clusters may have existed and allowed small firms to take advantage of agglomerations and untraded interdependencies to help them compete with large firms in a market that was by and large weak. In the Soviet period though the state did not plan for clustering, and as there was no competition there was no need for



agglomerations or untraded interdependencies; the state through the plan would perform these functions.

The economic environment of both periods and their respective formal institutions were not conducive to non-state small firm formation in the formal economy. This though did not mean that opportunities were not available, they were, but they were constrained by different factors. In the Soviet period opportunities could only be exploited informally, and in the Tsarist period were constrained by the slow rate of urbanisation which reduced consumer demand and by geographical fragmentation of the economy. Transaction costs were particularly high in the Tsarist period because of poor market information, state institutions that controlled the economic activities of each social class and poor legal protection of property rights. In the Soviet period the levels of transaction costs facing the co-operative sector were higher than for the informal sector. Co-operatives had to contend with state bureaucracy, regulations and a tendency for all state-owned enterprises to hoard all factors of production to guard against shortages. The informal sector on the other hand was outside state control, it did not have to observe state regulations and it had fewer problems obtaining factors of production because of the close connections between members of the administration and those involved in the informal economy. The extent to which opportunities were exploited though was also dependent on the socio-cultural environment, which affected the supply of potential entrepreneurs and attitudes to non-state firms as well as levels of trust.

The socio-cultural environment was shaped in both periods by the state, through the top down creation of the various social groups and their assigned work tasks, consequently the state also indirectly influenced the supply of independent entrepreneurs. Norms or informal institutions for each social group, especially in the Tsarist period, prevented many new emerging opportunities from being taken up, but



they also restricted innovation to business practices. In the Soviet period all social groups had different types of access to factors of production and this shaped the opportunity structure facing them. One legacy that was similar in both historical periods was the hostility towards non-state economic activity. This had as much to do with the state appearing to be weak by not having adequate laws and enforcement systems to protect consumers, as it did with state hostility towards it. The state used propaganda in both historical periods to limit involvement in non-state business, and it was helped by a partial judicial and enforcement system that protected state interests and property first and foremost. What is more, its existence was often socially recognised as being aided by corrupt bureaucrats. Historically the Russian people have never felt secure or protected from arbitrary state behaviour nor from less scrupulous business in the formal or informal economies.

Despite all the disincentives facing non-state small business in both the Tsarist and Soviet periods in the political, economic and socio-cultural environments, they still managed to exist. The fact that independent small business existed shows the determination of individuals to overcome the difficulties and constraints, to manage the risks and respond to the opportunities. This is a positive feature, which suggests that even in the hostile transitional environment of the 1990s small firms would have existed and would have learnt to cope with the difficult circumstances and even flourished. The next chapter will analyse how the emerging independent small firm sector responded when conditions changed and a nascent market economy was created, when the state changed the institutions in ways that in theory at least, should have been more supportive of independent small firms.



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## End Notes

<sup>1</sup> Other names for the informal economy include the shadow economy, the second economy, the counter economy, the unofficial economy, the parallel economy, the black economy and the underground economy. Here unreported income is made from conducting economic activities, and it is this that makes it illegal. In other words the goods and services are not illicit, rather they would be legal if they had been produced in the formal economy (Schneider and Ernste, 2002). The informal economy in the Soviet period did also include such illicit economic activities such as prostitution and drug trafficking but this chapter does not concern itself with this kind of informal activity.

<sup>2</sup> Co-operatives concentrated on producing consumer goods and services. Very few co-operatives went into manufacturing (Blackwell, 1994; Sakwa, 1991; Rutland, 1992). (See also point 11 for types of activities)

<sup>3</sup> Examples of this form of activity, which varied from over time, include, small artisan craftwork, moonlighting by physicians, teachers, builders, drivers, housing construction by housing co-operatives (Grossman, 1977). Food production on subsidiary (or personal) household (garden or private) plots was undertaken on land owned by the state or collective farm and allotted to rural residents for use. The collective or state farms provided seeds, livestock, feed and so on. Some industrial enterprises, hotels, sanatoriums and educational institutions also had plots of land to produce food for sale in their shops and use in canteens. Dachas (lychnoe podsobnoye khozyaistvo) were for urban people (Hedlund, 1989). These three different types of 'private' food production were important for relieving the official food system especially in remote areas. Although known as being private this term is not strictly correct, for the state still held their property rights, and inputs came from state or collective farms (Headland, 1989; Lerman et al, 1994). Even peasants producing food products on their garden plots were obliged to send much of their produce to the collective or state farm first for plan fulfillment, what was left over then went to kolkhoz market. Consequently private plots were only partly used for commercial gain. Between 1966-1985 just 20-30% of private plot output was sold commercially (Lerman et al, 1994). Part of the reason for this was difficulties with officials obstructing peasants getting produce to the market (Lerman et al, 1994).

<sup>4</sup> The Soviet press made it clear that there was no shortage of opportunities for extra plan activity in any consumer good sector (O'Hearn, 1980). As Kornai comments the Soviet command economy suffered from shortages as a result of its complicated planning procedure, but also because of the political wish to increase production but without creating the necessary incentives for workers (Kornai, 1995). For Grossman the existence of the informal economy is connected with bureaucratic corruption. Grossman wrote that one source reported that an official actively promoted enterprise in the informal economy in order to have a larger base from which to obtain bribes (Grossman, 1977). Nove also writes that emigres from Russia stressed how widespread corruption was in party circles (Nove, 1986).

<sup>5</sup> O'Hearn writes that Pravda on 29<sup>th</sup> September, 1975 reported one instance of large-scale manufacturing of television sets in the informal sector (O'Hearn, 1980).

<sup>6</sup> Firms were bought and sold on the informal market at prices that reflected their profitability and the nature of the risk. Large-scale informal manufacturing could only be undertaken in state-owned enterprises and involved a payoff to officials or managers to cover up its existence.

<sup>7</sup> The plan would eliminate mass unemployment, avoid over production, all innovations would be common property rather than secret and used for competitive advantage, there would not be a need for competition and its wasteful use of resources. Workers, by not being exploited, would be enthused to work harder, which would reduce the need for costly supervision. All this would enable the economy to grow and to achieve greater success than under capitalism. This would be achieved, not because economic policy was better, but because the system's inherent properties were superior, as they allowed people to work for themselves and for society (Kornai, 1992).

<sup>8</sup> Khrushchev 45 years later also complained that the administration continued to operate in the old Stalinist way, for personnel had brought with them their old luggage from their previous posts and had derailed the changes he wanted to introduce (Rutland, 1994).

<sup>9</sup> The Soviet state carried out a policy of ousting the capitalist elements from industry and trade. It limited their credit, and goods supply and imposed high taxes and prevented capitalist accumulation (Dzyubenko et al, 1979). In 1929 74% of the 4 million people engaged in small-scale industry were individual artisans during 1929-30 many were pushed or persuaded to join industrial co-operatives (Davies, 1994). In the food industry the decline in the numbers of small businesses was reflected in their output, so whilst in 1927-8, 63% of flour was produced in small-scale units by 1937 this had fallen to 26% (Timoshina, 2000).

<sup>10</sup> The Second World War also had an impact. Because of occupation in the south a number of small factories were built especially in the areas in the East and the Urals (Burgeinyi et al, 1979).

<sup>11</sup> Activities allowed were dry cleaning, taxi cab driving, restaurants, repair activities (Stuart, 1995); activities that were banned in December 1988 were those in such fields as film and video production, medicine and jewellery manufacture (Sakwa, 1991).

<sup>12</sup> Sometimes officials were not even interested in fulfilling the state plan, during one campaign against unearned incomes, officials forced a group of workers to wait for eight days for paperwork before allowing them on their way. This time delay caused their tomatoes to rot, which meant they were no longer fit for consumption (Hedlund, 1989).

<sup>13</sup> Not all food-processing plants were large, many were small (Govor and Schatkhan, 1983, Danilova and Mukhina, 1960). The size of plant was determined by a variety of factors including calculations about product spoilage and optimum distance from farm to processing factory, access to fuel, quality of the water, density and size of the consumer population, labour resources, transport links (Govor and Schatkhan, 1983). Other reasons for having small firms in the food industry were linked to the low density of the raw material base or due to insignificant raw material resources (Borisova, 1985). A poor resource base, however, did not necessarily always lead to the establishment of small-scale enterprises for example Moscow and Leningrad had large rather than small factories (Govor and Schatkhan, 1983). Industries in other branches of the economy also established their own food-processing enterprises to supply their workers and canteens with food products – for example in Rostov oblast the coal industry had its own conserve processing and canning factories (Blazh et al, 1981).



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<sup>14</sup> Accessing premises was also a problem. Although some state enterprises rented out space and equipment to co-operatives this was limited; some co-operatives were forced to rent space in unsuitable buildings and bear the cost of conversion and equipping them (Jones and Moskoﬀ, 1989).

<sup>15</sup> Inputs for co-operatives had to come from the state via Gosnab. Negotiations were tiresome and time consuming and there was no guarantee that inputs would be available. Consequently it was difficult to get reliable access to supplies, which co-operatives had to pay higher prices for than the state sector. These high costs for inputs were reflected in the final price to consumers, who often complained about such high consumer prices. This contributed to restricting the numbers of co-operatives and what they manufactured (Jones and Moskoﬀ, 1989).

<sup>16</sup> The other difficulty was obtaining sufficient finance from the state banking system. The state had control over the financial system, and Gosbank (the state bank) decided which co-operatives received finance, but sometimes it was often also only available with the payment of a bribe. Only short-term loans for small amounts were available and this made it difficult to buy equipment (Jones and Moskoﬀ, 1989). These kinds of problems discouraged investment in manufacturing co-operatives, or limited their scale of operation and accounts for why the majority of co-operatives were in the service sector.

<sup>17</sup> Co-operatives came into being in two ways, either an individual proposed to form a co-operative and the local administration allowed the registration, or the local administration decided what was needed and encouraged co-operatives to develop (Jones and Moskoﬀ, 1989).

<sup>18</sup> Co-operatives were independent of the state sector, however some were either formed by state enterprises or voluntarily entered into agreements with the state enterprises (Adshead, 1992). Co-operatives, that either produced goods to state orders or used inputs from state resources, had their prices determined centrally (Adshead, 1992). Co-operatives producing for state-owned enterprises had to use state fixed prices, which meant that their market orientation was destroyed. Only co-operatives that found a niche were successful (Rutland, 1992).

<sup>19</sup> Local officials found themselves in situations where harassing peasants was seen as the only way for them to avoid getting into trouble with their superiors. Hedlund describes various situations where overzealous officials in fulfilling their orders stopped individuals from engaging in commerce (Hedlund, 1989).

<sup>20</sup> Trading on the kolkhoz (farmers) markets can be profitable which gives officials opportunities to obtain 'gifts' of various kinds to overlook forged freight documents, or obtain better spots on the trading floor (Hedlund, 1989).



## Chapter 6

# Transformation and Independent Small Firm Formation in Rostov Oblast's Food-Processing Industry

### Chapter Outline

This chapter applies the conceptual framework to understanding what is facilitating or preventing the formation of new small firms in the post-Soviet period. It is well known that the post-Soviet transition period of the 1990s had not been entirely conducive to non-state small firm formation, even though they could now legally form in the formal economy. Even in Rostov oblast small firm formation although doing well compared to other regions, was far from booming. This chapter shows why, namely the incompatibility of the old institutions (both formal and informal) with the new institutions needed to support a market economy. The result of this incongruity was that the political, economic and socio-cultural environments actively discouraged small firm formation by not helping to reduce transaction costs sufficiently. This is not to say that opportunities did not exist in the nascent market economy. On the contrary a legacy of pent-up demand suggests they did, but the formal institutions of the 1990s restricted their take-up to the former state-owned enterprises or to firms in the informal economy. This indicates that the right institutions suiting non-state small firm formation in the formal economy during the 1990s had not yet been created. As with the previous chapter the analysis will begin with a discussion about the nature of small firm formation in Rostov oblast and the opportunities for it in the food-processing sector, before analysing the factors from the conceptual framework in the political, economic and socio-cultural environments.

## 6.1 Introduction

This chapter analyses the effects of transition, from an administrative command economic system to one organised on market principals, on non-state small firm (SME) formation during the 1990s. In particular this chapter will concentrate on SMEs in the food-processing sector within Rostov oblast. Although the 1990s is a relatively short period of time for a whole chapter analysing SME formation, there are reasons for this. One fundamental reason is to contribute to understanding the nature of the complexity of SME development, in an economic environment undergoing systemic change as a consequence of transition, and the continued influence on it of past formal and informal institutions.

Transition may initially appear as a 'one off' fundamental change to the economic system, but this thesis views it as a process because of the learning that both political and economic actors go through as they adapt. As the adapted



behaviour may be less than desirable, modification to formal and informal institutions will be inevitable. In Russia change to formal institutions has been both inevitable and frequent and this was not just because of the state's inexperience in designing market institutions. Rather it had more to do with the post-Soviet economic system being a hybrid, combining both formal and informal institutions from the previous Soviet administrative command system with those found in any market economy. This hybrid economic system in the 1990s was a mass of formal and informal institutional discordance, and it is this that was preventing SMEs from flourishing.

Although the state has expressed a need to encourage SMEs, formation rates have slowed since the mid 1990s (Aslund, 1997; Solymossy, 2002). To deal with this the Russian state (like other transitional countries) turned to the West with its experience of SMEs, and imported western style business support policies to benefit the SME sector (see Storey, 1994). The trouble was that the context of transition was entirely different to anything the West had experienced, and the problems facing SMEs in Russia were more complex. Furthermore unlike SMEs in the West, Russian SME owners had little experience of working in a market economy instead they used their previous experiences (including habits and routines) from the Soviet period to interpret what was happening and to inform their subsequent reactions. These Soviet influences though undermined the usefulness of a simple transfer of formal institutions (in the form of policy or remedies), that had not been adapted to address the transitional Russian reality. This however, had not been fully appreciated by foreign advisors and analysts (Stark and Bruszt, 1999; Pickles and Smith, 1998), who tended to have little knowledge of Russia's economic history, underestimated its continuing influence and attempted to guide change using unmodified western economic models.



Another reason for dedicating a chapter to the 1990s is that although there is plenty of research on SMEs in Russia, it remains fragmented and is characterised by narrow analysis through partial perspectives. This chapter addresses this by integrating the wealth of secondary data into a study, that examines in-depth the key influences on SME formation from three environments (political, economic and socio-cultural), which up to now has not been undertaken for Russia. Moreover, this secondary data is supplemented with original field data to achieve a comprehensive analysis of SMEs in one manufacturing sector. Lastly this chapter demonstrates that the framework, devised for this study, may be as easily adapted to a more detailed analysis of an economic activity over a short time span, as it is for a broad-scale examination of it through history, like those carried out in chapters four and five.

This chapter uses as a structure the conceptual framework, so after an examination of small firm statistics the following section will examine the *political environment*, state ideology and new formal institutions. This section shows that the state was far more concerned with helping large former state-owned enterprises to restructure, despite recognising and verbally endorsing the need to provide help to new small business. This should not be surprising. Mass unemployment as a result of restructuring might have risked not just social unrest but also alienating die-hard communists in the bureaucratic structures, and either one or both of these outcomes could have jeopardised the implementation of further pro-market reforms. Although the state placed great emphasis on large enterprises, it nonetheless made an effort from 1995 to be more supportive of SMEs, but as this chapter concludes the state could have been more creative with its policies and consistent in their application.

The chapter then examines the *economic environment* facing small business. In accordance with the conceptual framework it will analyse the opportunity structure in other words the influence of the region's economic geography, factors of



production, property rights, wage levels, consumption levels and transaction costs on SME formation. This section shows just how harsh the economic environment was for SMEs in general and specifically for those in the food-processing sector. In particular the nascent market did not provide the kind of business information that is taken for granted in more mature economies, nor was there the perception of sufficient protection of property rights or contracts. These factors combined to make transaction costs particularly high for SMEs, and it is this that accounts for why many SMEs in the 1990s were registered but did not operate. SME formation although an economic activity is nonetheless informed by influences from the socio-cultural environment, which is the subject of the fourth section of this chapter. In particular this chapter examines new social groups and their attitudes towards SMEs to find the potential source for a supply of future entrepreneurs. In the West this is normally the middle class, in Russia many of those with traditional middle class occupations lack sufficient income and savings to invest in SMEs. Another disincentive to SME entrepreneurship was the lack of trust in society, a cultural trait inherited from the Soviet period, which has not been helped by continued bureaucratic corruption and the activities of criminal groups. Certainly mistrust of state policies, the judicial and enforcement structures explains why many SMEs continued to engage (to a lesser or greater degree) in the informal economy.

Before discussing SME policy and the influence of these three environments it is necessary to have an overall impression of the numbers of small firm formations within Rostov oblast, and the extent of them in manufacturing.



## 6.2 Small Firms within the Food Industry in Rostov Oblast

Non-state SMEs emerged in Rostov oblast almost immediately and by the end of the 1990s it became one of the top ten regions in the Russian Federation with the most SME formations<sup>1</sup>. Statistics show that since the mid 1990s small business has played an increasingly important role in the economic profile of Rostov oblast and between 1995-9 the total number of SMEs increased from 12 to 27 thousand (Averchenko, 1999). Within the North Caucasus Economic area (which since May 2000 is known as the Southern Federal District) in the South, Rostov is the oblast with the most SMEs. Furthermore (as observed in other East European countries) one of the sectors where Rostov has been strong in developing small business has been within the food-processing sector (Shipilova, 1997; see Smallbone, 1996a,c, 1999a, re Poland and the Baltic states; Smith, 1996 re Slovakia).

### 6.2.1 The Number of Small Business Formations

Establishing the true number of SMEs throughout Russia, as well as in individual regions such as Rostov oblast, remains problematic due to the way statistics were collected<sup>2</sup>. As elsewhere in Russia statistics were first collected on small firms with up-to 200 employee's up-to 1995 and from 1996 with up-to 100 employees. There are other difficulties with statistics that need to be taken into consideration. They do not state the proportion of former co-operatives or former small state-owned firms in them, nor the proportion of registered but not operating small firms. Also regional statistical agencies do not always publish their statistics, for example in Rostov oblast the statistical year book for 1997 had still not been published by the end of 1998 (the time of the field research visit). Moreover statistics on SMEs were not always subdivided into different manufacturing sectors. So not only has this complicated



finding comprehensive statistics for the whole of the 1990s on Rostov oblast, it was also impossible to determine how many small food-processing enterprises were being established. Consequently this study could not examine systematically the rate at which small firms were forming year on year in the food-processing industry, all that the statistics could show were general SME trends.

The first statistics that exist on non-state small firms in Rostov oblast start from June 1993 (see table 6.1) when there were a total of 7,283 SMEs (with under 200 employees). By 1995 this had increased to 21,401, out of which 15.5% (or 3,315) were in the manufacturing industry. After 1995 and similar to national figures on SME formation rates the number of SME formations in Rostov began to decline so that by December 1996 the number of small firms had fallen to 20,177. The reduction in the numbers of small firms in Rostov oblast came to 1,224 but much of this reduction would have been due to the changes made to the statistical definition of what constituted a small firm. What is significant is that although the rate of SME formations fell, there was still an increase in both the numbers and the share of firms specifically in manufacturing. For 1996 the share of SMEs engaged in manufacturing increased to 17% (a total of 3,406). This figure meant that while the share of SMEs in trade, services and construction still remained significantly higher, numbers of manufacturing SMEs in Rostov oblast were beginning to increase too.

Although it is not possible from the statistics to show how well manufacturing was doing in the very late 1990s and in the early years of the following century, the general figures for SME formations in 1999 and subsequent years are illuminating. It seems that the short burst of small firm formations that occurred as a result of the currency crisis in 1998 had started to slow down and even fell by 2000. This indicates that the currency crisis did provide some opportunities for SMEs, however, once the market settled down again then either these opportunities disappeared or



the difficulties in the economy that had temporarily been hidden re-emerged and acted as constraints again.

Table 6.1 Number of Small Firms in Rostov Oblast			
Date	Number of SMEs	No. In Industry	% of total
1/6/93	7283		
1/1/94	12119	2256	18.6%
1995	21401	3315	15.5%
1/12/96	20177	3406	17%
1997	27235	????	16.2%
1999	27300		
2000	25500		
2001	25000		

(SOURCE: 1993 figures – Goskomstat, (1994); - 1994 figures – Ekost, (1995); 1995 figures - Goskomstat Rossii, (1996); 1996 figures - Goskomstat Rossii, (1997a); 1997 figures - Passport, (1998); 1999, 2000 and 2001 figures - Goskomstat Rossii, (2001)

The experience of Rostov oblast with small firm formation is not unique as it follows a general Russian pattern. The gradual change of direction in SMEs from trading activities to manufacturing was understood by academic researchers like Vilensky (Informant 15) as an indication that trading opportunities were no longer as good because of market saturation. In other words the opportunity structure appeared to have changed by the mid 1990s somewhat to the benefit of manufacturing SMEs. Interviews conducted for this research will show that this change had more to do with the gap in the market for domestically produced goods left unfulfilled by former state-owned enterprises. Whatever the true cause by the mid 1990s manufacturing in small food-processing firms began to develop.

Table 6.2 shows the numbers of SMEs in the various industrial sectors of Rostov oblast in 1996. The food industry, according to table 6.2, is the third most important sector in Rostov oblast for small manufacturing firms and justifies why the



Table 6.2. Branch Structure of Small Business in 1996 in Rostov Oblast		
Branch	Number	%
Total Number in Industry	3406	100
Electro Energy	11	0.3
Fuel Industry	2	0.06
Ferrous Metal	5	0.1
Non Ferrous	4	0.1
Chemical and Oil Technology	133	3.9
Machine Building and Metal Processing	1453	42.7
Wood Processing	379	11.1
Construction	228	6.7
Light Industry	443	13
Food Industry	390	11.5

(SOURCE Goskomstat Rossii Rostovskii oblastnoi komitet gosudarstvennoi statistiki, Rostov na Donu, 1997a).

food sector was chosen for this study. Table 6.3 is a break down of the sectors of the food industry in which SMEs were important, though since it is from a different source and taken from a different year, numbers are not directly comparable with table 6.2.

Table 6.3 Number of Small Firms in General Structure of Food Industry by Sub Branch in 1995		
Sub-branch	Number of Enterprises	Number of Small Enterprises
Food Additives	818	274
Baking	301	74
Confectionery	56	23
Macaroni	5	4
Animal and Vegetable Fats	275	123
Perfume	2	2
Spirits	9	5
Brewing	10	2
Fruit and Vegetables	84	21
Meat	595	40
Milk	153	34
Fish	114	18
Grain and Cereals	1103	34

(SOURCE Shipilova, 1997)

It must be stressed that the figures in table 6.3 do not provide an indication of the proportion of small firms that were being established in the various food sub-sectors in 1996. Rather these figures, apart from newly established SMEs, will



almost certainly include firms that were co-operatives from the Soviet era, or former state-owned small food-processing firms and even firms that were previously in the informal economy. What this table does show is that the sub-branches of the food-processing industry, which were more suited to SMEs tended to be those producing a basic food product with little value added. Most domestically produced food sold in Soviet Russia (and even in the mid 1990s) was unprocessed or had gone through only the most basic of processing methods. The level of value-added processing in food production was and typically continued to remain (in the former state-owned food-processing firms) much lower than in the West<sup>3</sup>. Consequently it was not surprising to find that SMEs were undertaking basic food-processing. In Rostov oblast the sub-branches that favoured small firms tended to be in the product areas of vegetable oil and animal oil processing, milling and processing of grain products, baking and basic meat processing. Academic research undertaken in Rostov during 1997 suggested some reasons why some food-processing sectors were attracting more SMEs than others (Shipilova, 1997). Firstly the sub-sectors of food-processing where SMEs were likely to form were where equipment (although reasonably modern) was also fairly cheap and allowed for small batch production. Secondly they formed in sub-sectors where they could successfully compete with large former state-owned firms.

Interviews carried out in Rostov oblast during September to December 1998 and during the preliminary research trip to Nizhny Novgorod showed that SMEs in baking were not competing directly with large firms, but were seeking niche markets. These niche markets were with retail outlets not supplied by former state-owned bakeries or (as in Nizhny Novgorod) to hospitals and schools. In addition these SMEs tended to be more involved in direct cash sales to members of the public (Shipilova, 1997). This provided these small firms with two major advantages in a transitional market, where barter was common and information scarce. Firstly it



guaranteed a monetary payment, which helped with cash flow, and secondly it was a valuable form of market research. Certainly the bakeries visited in Rostov had serving hatches through which they sold bread, biscuits, and macaroni to customers. Furthermore in Rostov it was common to observe small tankard trucks on the streets selling milk to people bringing containers to them. Though it must be stressed, it was not possible from these trucks to determine whether the dairy selling milk this way was small or large. This observation nonetheless demonstrated that the use of direct sales tactics were commonplace in the food sector. The SMEs interviewed had no need to compete directly with the former state-owned firms. They found that the market was large enough for them to co-exist alongside the large former state sector. In this sense they were fulfilling the classic SME role of gap filling in a fragmented market.

Although there is statistical and research evidence to show that SMEs were increasing in number in manufacturing in the late 1990s the general trend was for a slowing down of the total number of new SME formations. Many researchers such as Vilensky (Informant 15) concluded that SME owners were simply becoming more aware of the difficulties associated with running a small business. This chapter will concur with this opinion and show that the optimism of the first years of transition had given way to the realisation that transition was only progressing at a slow pace. This may explain why the slow down coincided with the general improvement in the economic environment, expressed by falling interest rates, greater availability of bank finance and lower social hostility (Gustafson, 1999), together with the development of both federal and regional policies to support SMEs. The general improvement in the economic environment and state programmes were expected to encourage a substantial and sustained emergence of new independent SMEs across most sectors in the economy in the period up to 1998. But after an apparently promising start new SME activity seemed to slow or even stagnate. In order to have a better



understanding of what was happening the next section will analyse the political environment and the state's activities, at the federal and regional level, to understand the extent to which it was constraining rather than enabling SME formation<sup>4</sup>.

## **6.3 The Political Environment**

This section is not so much interested in the role of politics in the sense of party political activity as much as the institutions, that the federal and regional states have developed that either directly or indirectly influenced SME formation. The first section briefly indicates the change to state ideology that facilitated the transition to a market economy and what this has meant for the role of the state in determining its level of involvement in economic management. It will then briefly discuss the major policies of privatisation, liberalisation and stabilisation and their influence on SME formation. There will be no attempt here to enter a discussion on the merits or otherwise of undertaking these reform measures. Rather the aim is to understand the effect that the implementation of these institutional reforms had on SME formation. The final sections will analyse the effectiveness of small business policy (a new institutional area in Russia, unknown before 1992) at both the federal and regional levels. Essentially this part of the chapter will show that SME support was not a priority and was ineffective on both the regional and federal level in the early years of transition. Moreover, it will become evident that the state has had a substantial indirect influence on SME formation.

### **6.3.1 The Role of the State, Ideology and Policy at National and Regional levels**

Soviet ideology, which guided conduct within the polity, economy and society, was made redundant when steps were taken in January 1992 to introduce elements of



the market into the Russian Federation. After all Marxism-Leninism and market democracy are polemically at opposite ends of the scale and the latter was now in the ascendant in Russia. The most significant change, apart from democratisation and free elections, was the state relinquishing centralised control over all economic activity. This fundamental change gave (in principal) more opportunities for independent SMEs to exist in the official economy.

### 6.3.2 Economic Policy

The state at the beginning of the 1990s disengaged itself from the minutia of economic control notably what and how much enterprises should produce, and instead concentrated on the economic management of the macro economy. The new institutions that *privatised* the state sector, *liberalised* prices and markets and permitted the use of economic levers to *stabilise* imbalances in the economy have not just affected large former state-owned enterprises, but by changing the economic environment have also affected the formation of SMEs.

*Privatisation* of state-owned enterprises was an important national economic policy in the early years of transformation in the 1990s that was largely undertaken at the regional level. The scale of the privatisation process was far larger than any ever attempted elsewhere in the western world. Consequently this made it controversial, but also difficult with many losers (the old, unemployed, (ex-state) workers and so on) and many winners (the nomenklatura, or the managers and bureaucrats of the Soviet system, many of whom became known as the 'oligarchs' in the 1990s). Although destatisation of all enterprises (including all Soviet agricultural and food-processing enterprises) was the main objective, by radically changing the economic environment it also impacted indirectly on small firm formation.



Privatisation of these large monopolistic state-owned enterprises did not create the kind of fair competitive environment that it was expected to. On the one hand the state still retained some shares in the former state-owned enterprises, including those in the food sector<sup>5</sup>, and as a Tacis representative in Moscow reported this interest would prevent the state from forcing unviable enterprises into bankruptcy. Rather many former state-owned enterprises often received masked subsidies such as debt canceling on old loans (Informant 14; see also website for FAO<sup>6</sup>). On the other hand these newly privatised monopolies<sup>7</sup> began behaving to type. In the food sector monopolistic food-processing enterprises forced lower prices on agricultural enterprises for their raw material and through their buying power monopolised the raw material trade<sup>8</sup>. The market for raw agricultural material was not helped by the re-organisation<sup>9</sup> of large agricultural enterprises as this failed to create large numbers of commercially viable independent *fermerskie* farms<sup>10</sup>. As a result *fermerskie* farms in Russia during the 1990s produced just 2% of agricultural output in a year<sup>11</sup>, which was insufficient to supply commercial small-scale processing (Wegren, 2000). The situation may have been different had *fermerskie* farms formed co-operatives, but according to Serova<sup>12</sup> there were plenty of social, psychological, legal and economic reasons this did not happen. Privatisation and the re-organisation of agricultural enterprises then, contributed to slowing down the development of small food-processing firms by crowding them out of the raw materials market and by preventing the creation of a national market for raw materials. Instead small food-processing firms have had to depend on state procurement agencies (Ioffe, 2001), which were poor sources of inputs as they only bought up insignificant amounts of Russia's total agricultural output in the 1990s.

As to whether the former state-owned processing enterprises were capable of crowding out small food-processing firms from the sales market (as opposed to the input market) the situation here was different. Unlike other economic sectors, Soviet



food-processing enterprises were organised on a much smaller scale. This was due to problems of transport, spoilage of fragile material and the need to feed a widely dispersed population. Thus the market was used to being served by several food-processing enterprises. If (as happened) the former state-owned processing enterprises reduced production levels then there was room in the market for new processing firms to establish. The privatisation of the different sized sales outlets that existed in the former Soviet Union may also have provided opportunities. Certainly the '*kolkhoz*' or farmers markets continued to exist and were supplemented by the development of kiosks (although they were more important as sales outlets for imported goods) as well as direct marketing. As a result small firms in the food-processing sectors were less likely to have been crowded out of the end sales market by the newly privatised former state sector enterprises.

The privatisation policy of the state held mixed messages for the formation of small manufacturing firms. Privatisation did provide opportunities by transforming the downstream and upstream sectors of the food industry into independent organisations. But privatisation on its own did not break down the already established links between the former state-owned enterprises (the large farms and large-scale food-processors). As a result any small manufacturing firms in the food-processing sector in the early years of transition had to operate within a more restricted environment, especially when accessing a reliable supply of agricultural raw materials. The fact that small food-processing firms were slow to be established may have in turn acted as a disincentive for agricultural workers debating whether to establish their own private *fermerskie* farms, especially when they knew individual farmers were likely to experience problems in selling their output for a reasonable price.



Although privatisation was an important economic policy, it was arguably price and market *liberalisation*, which had the greater potential to determine how SMEs including those in the food-processing sector would develop. This was because liberalisation would (in principal) enable them to access inputs from anywhere and to sell to anywhere a functioning market existed. Moreover it gave any firm the right to determine its own price level for its products, taking into account local market conditions. The actual slowness with which SMEs were formed in manufacturing sectors like food-processing though appears to have had more to do with the manner in which both price and market liberalisation were implemented.

In January 1992 the state decontrolled the prices of most agricultural inputs which increased to world market prices (OECD, 1988), except those that were controlled through the state procurement system. At the retail level the federal state retained price controls on some 18 basic processed food products<sup>13</sup> by fixing the mark up for retailers and regulating the margins for processing enterprises (Serova, 1999). Regional governments were allowed to modify this list but it had to be paid for from the regional budget. By March 1992 practically all price controls on food were handed over to regional governments, apart from flour prices, which remained under federal state price control until the end of 1993 (OECD, 1998; Serova, 1999; FAO<sup>14</sup>). The limited ability of regional budgets to support food prices meant that by the end of 1992 the only products that most regions continued to support were bread and milk (Serova, 1999). Price controls on both these products remained widespread throughout the 1990s (EBRD, 1998), and in 1998 were still in force in Rostov oblast, where the cost of white bread was set at 2 roubles.

The question now is how did liberalisation and price controls affect SME formation? Any sector that has price controls set by the state for its output, whilst still paying free market prices for its inputs is unlikely to provide enough of an incentive



for an SME to be established. This, however need not always be the case. In Rostov oblast as in other regions in Russia small independent bakeries established despite bread prices in many regions being heavily controlled by the regional authorities. As price controls were levied on white bread, most small bakeries subsidised this by producing an array of other bread products, which retailed at market prices. In Rostov oblast one baker interviewed produced 16 different types of products (Informant 7). A similar strategy was needed in other food sectors such as the meat industry, which was not so much constrained by price controls, but which experienced decreased demand as a result of retail price increases. Evidence from Rostov newspapers shows that by the late 1990s small meat processing firms had been established selling a variety of meat products at lower prices than the former state-owned sector (Pogontsev, 1998a, Ivanova, 1998). Consequently price liberalisation and continuing price controls were not a sufficient hindrance to the formation of new small food-processing enterprises, once SMEs had learnt to cope with a regime of partly fixed and partly market determined prices by the late 1990s.

Price liberalisation also occurred at the same time as market liberalisation, which brought competition from products produced inside and outside the region. As commented above the fall in production by large monopolistic food-processing enterprises throughout Russia meant the gap in the food market was increasingly being met by imports of foreign food products. Certainly compared to the Soviet period when basic agricultural products dominated, foreign imports in the post-Soviet period were monopolised by high value-added processed food<sup>15</sup>. Moreover, even after domestic food production started to recover imported food products still remained popular (Mitchell, 1996).

Mitchell estimated that processed food products represented 30% of all imports into Russia in 1994 and 1995 (Mitchell, 1996), which between 1991-5 caused



on average a 20-40% fall in the consumption of domestic products (Sergeev, 1997). Imports of butter for example increased in 1994 by 68% and vegetable oil by 270%. Imports of frozen meat increased by 35%, though this was largely unprocessed and used mostly by meat processing enterprises throughout Russia, including some large meat processing concerns in Rostov oblast (Mitchell, 1996; Goncharov, 1998; Informant 6). The result was that by 1996 food products came to a quarter of all imports into Russia (Goncharov, 1998). The kinds of food products that have been imported in substantial quantities were for example baby food, confectionery, fruit juice, dairy products, processed and tinned meats, pet foods, snacks, tea and coffee (EIU, May 19, 1997). This though disguises the differences between the regions in the share of foreign imports of food products. In 1994-5 the level of food imports sold in the two largest cities of Russia (namely Moscow and St Petersburg) reached 60% of the total volume of food products sold (Zolotarev et al, 1995<sup>16</sup>). Whilst in the North Caucasus the share of imports into just three oblasts (Rostov oblast, Krasnodar krai and Stavropol) came to no more than 25%, but even though this was a low figure it still represented an increased volume (Zolotarev et al, 1995). From these figures it is possible to conclude that unlike other Russian regions import competition was lower in Rostov and may not have been a major problem for firms either large or small (that were not competing directly with foreign imports) in the early phases of transition during the 1990s.

Apart from imports, competition can take the form of investment by foreign companies into the food-processing industry. The bulk of foreign direct investment has been concentrated in the cities of Moscow and St. Petersburg. Although foreign investment was active in the food industry in Rostov oblast during the 1990s, it was more restricted. One particularly popular sector for FDI here was in beverages, for example in Donpivo (the joint venture of a Finish firm and the Baltika brewery from Leningrad Oblast) and Coca-Cola also has a joint venture (Solovova, 2000). The



reason why Rostov region may not have been popular for foreign investment was that the region (together with its neighbouring regions in the North Caucasus) had fewer wealthy citizens than Moscow and St Petersburg. Moreover it is a substantial distance from these two large cities and the high costs of transportation to them ruled out using Rostov region as a food-processing base.

Domestic competition, especially from processing firms within the same sub-sector and oblast, was perhaps more important. Soviet location theory ensured that each oblast had several bakeries, fat refineries, meat processors, and various other types of food-processing enterprises. As a result food-processing was one economic sector where intense domestic competition from within regions themselves was more likely following liberalisation/privatisation. This might suggest that there were limited opportunities in this industrial sector for SMEs. But gaps in the market had emerged because many large food-processing enterprises had decreased their output, as a result of technical obsolescence<sup>17</sup>, fall in consumer demand and as a strategic measure to obtain monopoly profits. SMEs like those interviewed in Rostov oblast entered these market gaps and provided consumers with a choice of quality products at competitive prices (Shipilova, 1997; Informants 7 and 10).

One factor that may have limited the development of small food-processing firms was state interference with the development of markets between the regions. The regionally administered policy of price controls on some agricultural products brought with it another set of institutions in the form of regional controls which prevented the export of these products to other regions (Severin, 1995; OECD, 1995; Serova, 1999a)<sup>18</sup>. For many SMEs this was unlikely to have been a serious impediment, because it probably would not have been viable for them to have engaged in exporting to and selling their products in other regions (Russian SME Resource Centre, 2001). Instead SMEs would have concentrated on selling their



products within the home region before attempting to search for customers in neighbouring regions. Where a problem might have existed would have been in sourcing and purchasing inputs from other regions. Yet again it was unlikely that small firms would have had the means with which to obtain information about market conditions or raw material prices in other regions. The situation was different for former state-owned processing firms, because they still relied on the Soviet *tolkach* (pusher/expediter) practice for their survival (Informants 6 and 8<sup>19</sup>). Small firms would only have benefited from this system if the owner had in the Soviet period been involved in the *tolkach* system or knew someone that was. Evidence from interviews suggests that some SME owners did have these kinds of contacts, which gave them access to inputs from outside the region (Informant 7). Using informal contacts in this way indicates that the marketisation of the economy was still largely incomplete, and that liberalisation had at best created an imperfect market with high transaction costs that may have acted as a disincentive to investment. It was predominantly the large former state-owned enterprises or well connected SME managers that had access to good information and the potential to reduce these transaction costs.

Overall competition as a result of market liberalisation was in itself not a prohibitive factor in the food industry in Rostov oblast. On the contrary, liberalisation created opportunities in the food industry, which attracted new small food-processing firms. These opportunities existed because large enterprises had cut back production, and imports of processed food products (at least in Rostov region) remained low. It was on the side of sourcing inputs (the market for raw materials) that the consequences of liberalisation were less positive for new firms. Nonetheless although liberalisation was important in providing opportunities for small firms, there was still a need for a stable economic environment if opportunities in the food sector were to be exploited.



A stable economy with low inflation is necessary for encouraging investment in SMEs and one *stabilisation* policy that influences the inflation rate is control of the money supply. In Russia inflation was especially difficult to control between the years 1992 and 1994, due to a swing back and forth between a tight monetary policy<sup>20</sup> and the inherited Soviet policy of issuing subsidised credits<sup>21</sup> to struggling industry such as agriculture. For example in Rostov, the share of the regional outlay for agriculture in the budget increased from 29-63% between 1992 and 1995 (OECD, 1998a). This was because of the importance of agriculture to the region and also because of the financial resources available to the regional government. The number of subsidies though fell significantly after 'Black Tuesday' in October 1994 and contributed to a lowering of inflation that created a more stable economy between 1995-1997. This stable economy however, did not prevent agricultural production from continuing to fall and the ensuing negative impact this had on the output of processed food. The whole of the food industry remained in a state of depression during 1997 in Rostov oblast, though there was evidence of a slight improvement in agro-industrial production as some processors developed new products using local raw materials (Zimovets, May 1998). Economic instability returned again in the second half of 1998 following devaluation in the late summer and both industrial and agricultural production fell sharply. This negative impact on production though was temporary, as devaluation caused the prices of imports to increase substantially, which reduced demand for them and opened up gaps in the market for domestic Russian products<sup>22</sup>. Although Rostov oblast imported fewer products and suffered less from high rates of inflation the prices of these imports were still high, and this was particularly beneficial to the food sector (Molot, October, 1998). Certainly in Rostov oblast in the last quarter of 1998 the total output of industrial goods and services (which would have included processed food) in September exceeded the August amount by 15.2%, and demand in September 1998 compared to September 1997 grew by 24.6% (Molot, October 1998).



Apart from causing inflation the other problem with subsidies in Russia was that they did not encourage the receiving enterprise (usually a former state-owned enterprise) to improve financial discipline. This gave some former state-owned enterprises an unfair advantage, which did not create the kind of competitive environment that encouraged investment in SMEs (Brooks et al, 1994; 1996). Moreover, the mere existence of subsidies can discourage commercial banks from providing short and long term loans that could prompt an industry's adaptation to consumer signals (OECD, 1998). In agriculture the existence of subsidies helped to maintain established Soviet links between the up-stream and down-stream sectors, and this prevented the adjustment of agricultural production to the kinds of quality products new food-processing firms were seeking. It was only in 1998 when devaluation and the currency crisis temporarily gave SMEs an advantage that they increased output.

The privatisation, liberalisation and stabilisation policies of the state were designed specifically to aid the large former state-owned enterprise adapt to the new economic environment of a transitional market type economy. They were not designed to help SMEs compete on a level playing field. As a result of these policies it was initially problematic for independent SMEs to operate in manufacturing sectors at the beginning of the 1990s. Undertaking an exchange (obtaining information, sourcing inputs, selling output) involved higher transaction costs for SMEs than for the former state-owned enterprises. This was because former state-owned firms already had established sourcing and marketing links, and could rely on direct and indirect subsidies to cushion them from market shocks. In short these new policies did not alter the way the former state-owned enterprises did business amongst themselves, nor initially the way the state used the old tools of subsidies and other economic measures to support them. Consequently the behaviour of the former state-owned enterprises and bureaucrats followed the traditional path that existed in



the Soviet period. This restricted the opportunities available to manufacturing SMEs, though there were market opportunities within some sectors where there were price controls (for example in baking), and also in the period after the 1998 financial crisis when devaluation drove up import prices.

In privatising and liberalising the economy a change to the *law* was needed. Previously the state had controlled and designed laws that were more suited to protecting its own power and dominance over all economic activity. A new legal framework (in other words a new set of institutions) had to be designed to protect private ownership and enterprise and to restrict state interference. Together with enforcement the law had to be seen to protect individuals from an overzealous or corrupt state and make sure that individuals, irrespective of their status, were penalised for not following the law. Law and enforcement then were important elements of the political environment that need to be analysed next.

### 6.3.3 Law and Enforcement

Transformation involved separating the state from the judiciary, law and enforcement, which were now to be independent and capable of protecting individuals from state abuse of the law (Rausser, 1993). One of the principles of transformation was that new legislation should support the development of non-state private business, the enforcement of contracts, protection of property rights and legal savings. These important institutional changes were beginning to take place in Russia, but to many researchers such as Gustafson the protection they provided was ineffective (Gustafson, 1999). Ineffectiveness partly stemmed from the implementation of new laws that often contradicted the old Soviet laws that remained in force (Bruno, 1997). This created confusion not just for the judiciary and for SMEs owners but for the bureaucracy, that could now decide which laws to follow and had more opportunity to



engage in some rent seeking (Gustafson, 1999; Trunk, 2000). Consequently SMEs which “wanted to stay within the margins of legality were likely to have found it difficult to do so since by observing one law they may have been breaking another” (Bruno, 1997). Transformation of law and enforcement in the 1990s then had a negative rather than constructive effect on new firm formation because of the additional uncertainties it created, and moreover made planning business development virtually impossible (Avilova et al, 1996).

Uncertainty about legislation (EBRD, 1997) together with ineffective judicial and enforcement procedures meant that arbitration courts were still not used for protecting legitimate contractual non-personal business transactions<sup>23</sup>. Low court usage also reflected the experience of the Russian public with the Soviet court system that only protected the state and other powerful interests. Continued bureaucratic rent seeking made easier by vague and incomplete legislation did nothing to counter this impression or improve the reputation of the law in the eyes of the general public (Gustafson, 1999). In addition, if the state at various levels was capable of ignoring the law (for example bankruptcy law) when it pleased, then it was hardly surprising that SME owners ignored the law, or were reluctant to use the courts to protect their business interests (Aslund, 1997b; Gustafson, 1999; Blasi 1997). Legal confusion also encouraged the use of loopholes and this contributed to perpetuating the ‘*culture of law avoidance*’ inherited from the Soviet period. In turn this hindered the adoption of key business practices like contracts, which are central to a market system, causing business transactions in Russia to remain restricted to known business partners.

Apart from the law inadequate *enforcement* also contributed to holding back legitimate business activity. Businesses found that the cost in time and money in taking a case to court was unlikely to be recovered because the success rate of



executing court decisions was low (Easter et al, 1998; Frisby, 1998). This happened for two reasons. Firstly because the burden of work on enforcement agencies had increased substantially, but wages and resources had not. Secondly because many businesses used armed security guards to prevent the police or other enforcement agencies from enforcing court decisions (Gustafson, 1999). The message business took from this was that there was limited legal protection and enforcement, and this left them vulnerable to opportunism.

For most SMEs this weak legal and enforcement system forced reliance on personal connections, recommendations (Gustafson, 1999; Dolgopyatova, 2000) or on obtaining 100% pre-payment (Easter et al, 1998). Although personal connections increase certainty in business relations and decrease transaction costs they can restrict business growth by limiting networks of business links. For example in Rostov oblast during the 1990s the various food industry unions used their personal connections both within and outside the oblast for business deals (Informants 6 and 8) on behalf of their own members (the former state-owned enterprises). This support though was not extended to the new businesses that were forming in the sector. These kinds of business deals contributed to the difficulties new small businesses experienced when attempting to gain access to factors of production. More importantly during transition the widespread use of personal business relations in Russia has contributed to keeping the reform of company law a low priority and promoted the use of the shadow justice system (paid for by protection money - a sort of informal tax) (EBRD, 1997; Gustafson, 1999).

Improvements in legislation and enforcement may also have been neglected somewhat by the state because its small business policy was designed to compensate for inadequacies in the macro economic environment. Unfortunately this was an area of institutional reform that was new to the state, and as the next



section will show, turned out to be less supportive of small business than it could have been.

### 6.3.4 The State and Small Firm Policy

The state began issuing laws supporting SME formation from 1993 onwards; before then it only had Soviet laws on co-operatives and independent economic activity. The first programme dedicated to SMEs came into existence in 1995 but it signified that the state was beginning to take the issue of SME support more seriously. Apart from changing the definition of SMEs the first programme proposed some specific SME support measures including changing laws, legalising financial support funds, developing innovation centres, SME advisory centres and educational establishments.

Federal SME policy may have been developing in the mid to late 1990s, but its coherency was hampered by the responsibility for it being changed between departments and ministries<sup>24</sup>. For example the Ministry of the Economy was initially given the function for co-ordinating SME policy, then in 1995 it was handed over to the Russian Federal State Committee for the Support and Development of Small Business and in 2000 to the Ministry of Trade and Economic Development. This lack of continuity over the lead federal body responsible for SME policy and the sheer number of bodies that had some input into policy not only created confusion but also duplication of support measures. This lack of co-ordination indicated that not only was the state SME support still in its infancy, but it was still a low priority. Nonetheless, the state with its first federal programme for SME support in 1994-5 in drawing up plans to provide a financial infrastructure, information, personnel support, export support and technological assistance did at least attempt to create a more favourable environment for SMEs. Responsibility for the implementation of these



measures and of policies like taxation, registration and certification were transferred to the local level. Unfortunately though the involvement of the local administration did not improve implementation. Consequently federal small business policy actually had the opposite effect to the one intended, and it is this that will be examined below through looking at some of the most important areas of policy to affect SMEs.

#### 6.3.4.1 Taxation of Small Business

Taxation of SMEs in Russia was generally considered excessive during the 1990s and the roots for this lay in the previous economic system. During the Soviet period the state collected revenue for the budget from state-owned enterprises (after the sale of products and deduction of costs), leaving only some petty cash and enough in bank accounts to pay for factors of production. In the 1990s privatisation and the sharp fall in productivity of former state-owned enterprises meant a shortfall in revenue entering the budget (Kagarlitsky, 2002). In the new market economy that was being created this shortfall had to be made up by the new private sector.

The taxation burden on small business was high but increased further when in 1993 the right to levy taxes (charged at discretionary rates) was extended to the regional and local levels of state and was in addition to federal taxes (Easter et al, 1998). It has been estimated that a small business was required to pay around forty to fifty taxes (including for example profit tax<sup>25</sup>, VAT, property tax, social fund tax, and tax on supplementary costs (OECD, 1998b)), which would take approximately 80-90% of its profits (Chokh, 1997). Business was not helped by the vagueness of wording on normative documents and the power this gave to local tax officials to make arbitrary decisions, request payment for information and back date tax arrears (out of which they received a percentage) (Easter et al, 1998; Avilova et al, 1996; OECD, 1998b). Consequently it was not surprising that many SME owners found



that the corrupt or incompetent tax inspectorate frequently made erroneous decisions (Easter et al, 1998) against which they were powerless to protest. Consequently taxation was seen as a form of state racket and acted as a disincentive to SME formation and growth around 1994 (Avilova et al, 1996). More importantly state taxation policy appeared to be “deliberately steering the SME sector into the informal economy” (Avilova et al, 1996) as SMEs attempted to avoid paying taxes.

Tax avoidance<sup>26</sup> by SMEs (Chokh, 1997; Gustafson, 1999; Easter et al, 1998) was initially relatively easy because of an inefficient collection system (EBRD, 1998; Gustafson, 1999). As SMEs learned to evade high taxes they made fewer demands for a change to the system (Gustafson, 1999). Avoidance of state measures like taxation was nothing new, as chapter five showed misinformation, concealment and stealing were commonplace. But in the post-Soviet period there was a deepening of this culture. This too had serious repercussions for SMEs for it contributed to increasing the budget deficit<sup>27</sup>. This meant there was less revenue available for state expenditure on essential infrastructure (transport) and small business infrastructure (such as support agencies and incubator centres) as well as other social payments, which in turn contributed to decreasing consumption levels and sales of SME products (see also Dana, on Peru, 1998).

Since 1995 there have been debates at the federal and regional level about lessening the tax burden on SMEs. One method that had been mooted in some regions like Rostov oblast was the simplified or single tax, and although it had not been introduced by the end of 1998, newspaper reports expected it to be in operation from January 1999 (see for example Poyurova, (in Gorod N) November 1998). If newspaper reports were right, and the single tax was introduced, then articles about its ineffectiveness elsewhere in Russia are likely to be applicable (especially as Rostov has tended to copy federal programmes). According to a national survey in



2002 very few firms were using the new single tax system (Zhuravskaya, et al, 2002). The preference for the old tax system was not a simple rejection of something new that was difficult to understand, but because avoidance may have been less easy. This shows how difficult it is to change an institution when evasion is culturally embedded. Moreover such ingrained evasion indicated that even lower tax rates would not have guaranteed that revenues would have increased (Gustafson, 1999).

Taxation was often seen as the most important bureaucratic obstacle to small business formation and which for existing firms increased transaction costs. There was though some opportunity to reduce transaction costs through avoidance, which was not always the case for others such as registration and licensing.

#### 6.3.4.2 Registration and Business Licensing

The registration of SME activity can be a significant 'starting up' cost that can deter new entrants if it is so high that it delays reaching the break-even point. In Russia it was not just the financial cost of registration that was high in the early 1990s, but also transaction costs incurred such as the time taken to arrange registration and obtain the necessary licences. Registration did reportedly become easier towards the end of the 1990s, as a result of regulations preventing local authorities breaching the licence issue period of one month (see surveys reported in Easter et al, 1998). Certainly the small businesses interviewed in Rostov oblast confirmed that licensing was not problematic and took three to four weeks (Informants, 5,7 and 10). This though should not be taken as conclusive proof that officials always followed the time frame of a month. Moreover, the ease they expressed when following this bureaucratic procedure may well have been relative to their experiences in overcoming other more elaborate bureaucratic obstacles that they had encountered in the past as well as at that time.



Although business people may have become used to the length of time it took to register a business it was still nonetheless a very complicated bureaucratic procedure during the 1990s. For example to register, a small business typically had to obtain permits from about 20-30 local officials and agencies (Gustafson, 1999), which were not always in a hurry to give their approval. Part of the problem with registration was that the regional authorities could adapt the registration procedure. For example Easter et al reports that it was not unusual to find that businesses could often only register in sectors that coincided with the region's economic policy (Easter et al, 1998) rather than according to the needs of the market. Bureaucrats also followed their own interpretations of registration laws (Braun, 1997) and this plus their low wages encouraged them to engage in rent seeking practices when dealing with registrations from applicants wishing to hurry this procedure (Braun, 1997).

Apart from registration most businesses needed licenses before consumer goods could be traded, a legacy inherited from the 1980s that was used to control co-operatives (OECD, 1998b; Easter et al, 1998). The problem was that even by the end of the 1990s licensing was not properly regulated by a federal law, which meant there was no Russian standard for licensing applicable throughout all regions<sup>28</sup> nor was there a set national licence fee. The national state tried to restrict the scope of regional licensing (see governmental resolution 1418 issued in December 1994), but because regions complained about restrictions on their power and loss of revenue, some 33 licensable activities remained as a concession (Easter et al, 1998). Some regions though were not satisfied with this and attempted to illegally extend the numbers of activities subject to licensing (Easter et al, 1998). This attempt by local bureaucrats to manipulate licensing confirmed the view of many SME owners that licensing was a way for regions to obtain funds rather than a mechanism to ensure standards of production or consumer protection.



The food industry in Russia is also regulated by mandatory product certificates which have to be renewed annually (Easter et al, 1998). In Rostov oblast the owners of SMEs in the food-processing industry that were interviewed said there was a need to gain certificates for any new products they introduced that differed in any way from the old Soviet standard recipe. The main problem they had with this was not the financial cost, but the time consuming bureaucratic procedure to get a product certificate (Informant 7). This procedure was not helped by the closure of the scientific technical information centres in the early 1990s, which made it difficult to find information on product standards.

Many SME owners attempted to reduce transaction costs on certificates by buying forged ones from the informal economy or by selling several products under one certificate. SMEs that did this contributed to the ineffectiveness of the certification system to protect consumers. Certainly reports in local newspapers about potentially harmful bread and meat products attested to the inability of the regional authorities to protect consumers from sub-standard food products (Pogontsev, October 1998; Vechernii Rostov, 17<sup>th</sup> September 1998). This ultimately did nothing to support the reputation of the domestic food industry, but it also contributed to maintaining low levels of trust in official bureaucratic procedures.

Since 2000 the federal state has attempted to decrease transaction costs by reducing administrative barriers. The measures that the state has introduced include setting time limits on obtaining licences, easing the certification process, reducing the numbers of inspections and simplifying the taxation system. Unfortunately reports in 2002 express that it was still too early to establish whether these attempts were successful, although the monitoring work carried out by CEFR (Centre for Economic and Financial Research) has indicated that there were some positive changes. For instance costs for registering and obtaining licenses had fallen, even if not to



stipulated levels. The time taken to register fell although it remained longer than the required five days and licence terms were for longer periods of time, but often less than the specified five years. Another positive development was that there were fewer inspections by various administrative bodies, which meant that there was a reduction in the time taken up with this for many SMEs. Unfortunately this did not mean the end to unplanned inspections and demands for illegal payments, especially from fire safety inspectors, sanitary inspectors, police and tax inspectors who from time to time continued to violate the law (Interfax, 5<sup>th</sup> February, 2003, Shanghai Poverty Conference). The one major disappointment continued to be the ineffectiveness of the simplified taxation system (CEFR, 2002). Despite setbacks there was a general move in the right direction to reduce transaction costs by reducing and eliminating many of the administrative barriers facing SMEs, but there was still a long way to go. Consequently transaction costs and administrative barriers were major contributors to the low rate of small firm formations.

Apart from reducing administrative barriers, some regions such as Rostov oblast have implemented small business support measures to encourage an increase in small business formations.

### 6.3.5 Regional Governance and Regional SME Support Measures

The federal programme for the support of SMEs established that the regions would have some autonomy to create their own SME policy that would be co-financed from the federal and regional budgets. Unfortunately when the federal financial support was reduced so too was regional government support (Shipilova, 1997). Moreover regions like Rostov oblast tended to copy federal policy rather than developing distinctive locally tuned policies, so these regional support programmes were often



far from innovative (Easter et al, 1998)<sup>29</sup>. This may have reflected the Soviet tradition of regional state subordination to the center, or it may simply have been that the regions were overwhelmed and inexperienced in designing policy (Easter et al, 1998).

Rostov oblast developed a programme (see footnote 28) that was intended to be fully comprehensive, though many of the projects had still not been implemented by the late 1990s. This was partly due to financial restrictions in the regional budget, but it also indicates that the oblast administration saw SMEs as being of lower priority than for example providing sufficient subsidies to established large industry and agriculture. Certainly newspaper reports in the local *Gorod N* newspaper provided many examples of large firms obtaining regional support to re-start their production (Burakov, 1997; Bakeev, June 1998), though during the period of the field research there were no newspaper reports about SME successes having used regional support initiatives. The issuing of a small business programme, unadventurous as it was, did at least provide the oblast administration with the appearance of being active in small business support, even if in reality there was little happening. This was particularly important for obtaining funds from the federal budget and for being noticed by federal state officials as well as the general public in Rostov oblast at times of elections.

Since the beginning of the SME support programme, each year Rostov region has concentrated its actions on several specific areas of support. For example in the first year of the programme (1995) the region set up the fund to support SMEs. This fund provided credits to SMEs that had won an annual competition, at advantageous rates. In the first year thirty businesses applied but just five obtained credit, two of which were in the area of processing agricultural goods. In 1996 the number of SMEs entering the competition fell to thirteen, eight were deemed suitable for the



competition but only four obtained help (Shipilova, 1997). The lower number of applicants entering the competitions in subsequent years reflected that the business community drew its own negative conclusions about these competitions. The unlikelihood of obtaining funds was one reason why none of the SMEs interviewed during the autumn of 1998 had entered a competition. Another reason was that they would have been required to provide detailed information to the authorities, and this may have left them vulnerable to rent seeking bureaucrats. Consequently the businesses interviewed obtained funds from other sources, including re-investment of profits, private investors or from such organisations as the USAID 'Opportunity' fund or the 'US-Russia Investment Fund' (Informants, 5,7 and 10).

Rostov oblast, like many regional authorities, failed to take advantage of the law that gave them a certain amount of autonomy in creating their own regional support programmes (Shipilova, 1997). This could imply that Rostov was indifferent or conservative. The more likely reason was that regional SME support was in its early stages and local policy makers were unsure what to do. This helps to explain the delays in implementing the simplified or single tax system and in opening SME incubation centres<sup>30</sup>. Other programmes such as the ones providing business education to SME managers (in the 1997 programme) had not been reported on by the end of the research visit in December 1998, so the impact of these programmes remains unknown<sup>31</sup>. As success is likely to have been reported in the local press one can infer that the lack of reports on them suggests that they either did not operate or were not particularly successful. So the expectation that regional political autonomy would produce experimentation or innovation in such policy areas as SME support has not been borne out when looking at the experience of Rostov.



### 6.3.6 Small Business Formation and the Political Environment

The federal government throughout Russia including Rostov oblast in the 1990s failed to introduce the kinds of formal institutions that would have created sufficient legal protection for legitimate business and incentives in the economic environment that would have encouraged SME formation and growth. An attempt was made to create the legal basis for a market economy and to provide it with the essential features of the market through privatisation, liberalisation and stabilisation policies. This though did not mean that SMEs operated in either an economic or legal environment that put them on an equal footing with the former state-owned enterprises. On the contrary, SMEs lacked the networks of information that helped former state-owned firms, and they were less likely to be awarded subsidies and state contracts. They were though more likely to declare bankruptcy; moreover regional support programmes designed to redress some inequalities were so inefficient and underdeveloped that they were not easily accessible and little used. The only way the SME sector could survive with these formal institutions was to operate either wholly or partly in the informal or shadow economy. In other words the political environment remained inclined towards supporting the large former state-owned enterprise rather than encouraging small firm formation. The next section examines how formal institutions influenced the operation of the economic environment and the effect this has had on SME formation and growth. In particular this section analyses regional economic conditions in Rostov oblast, the growth of the consumer market and the operation of the factor markets.



## 6.4 The Economic Environment

As the previous sections showed formal institutions introduced by the state will have set the parameters for activity in the economic environment. Nonetheless although the constitution accommodated SMEs, opportunity seeking and SME activity remained muted in the formal economy in Rostov. This was largely in response to the harsh economic environment in the 1990s that was shaped by the region's geography, low consumer demand, low wages, high inflation and difficulties accessing factors of production. The following subsections aim to analyse conditions in the economic environment during the 1990s, that were influencing the low rate of SME formation in Rostov but also preventing them from fully exploiting opportunities in general and in the food processing sector, starting with the role of geography.

### 6.4.1 The Role of Geography and the Transport Infrastructure on the Economic Environment

There are two ways in which geography influenced economic activity such as small firm formation in the regions of Russia. Firstly, as Lynch has argued costs of production increase in response to the severity of the climate, huge distances (which also includes the separation of the population from the natural resources), and reliance on land transport (Lynch, 2002). Secondly the legacy of Soviet regional autarky policy, that often located industries in areas that were climatically unsuitable or lacked the right kind of natural resources, meant that they would be unlikely to survive in market conditions without subsidies. Rostov region is at least lucky in both these respects as its geography and less harsh climate is suitable for sustaining a myriad of different industrial sectors including food-processing. This section consequently needs to address the other ways that geography impacted on the food-



processing sector in Rostov oblast and the implication this might have had for SME regional policy.

Unlike the majority of Russia, Rostov can perhaps be compared to southern Canada, having less severe winters and much longer summers. As a consequence its geography is suited to agriculture and the food-processing sectors. Moreover, unlike many other regions in Russia it is on the same time zone as Moscow, which eases communication with the capital. In Rostov rather than a lack of different communication and transportation modes (good by Russian standards), it was the poor state of this infrastructure in the 1990s after decades of under-investment. This poor transport infrastructure contributed to the high costs and delays in transporting goods to or from other regions. In addition within the region itself the transport infrastructure was so poor that it prevented the new *fermerskie* farms from reaching local markets and moving into commercial production (Serova, 1999a).

Apart from problems associated with accessing raw agricultural materials and markets another geographical issue, inherited from the Soviet period that might have affected SME formation rates in Rostov oblast, was the lack of clustering by former state owned food-processing enterprises<sup>32</sup>. Without established clusters of industry new SMEs in the 1990s did not find pre-existing pools of information or skills and were unable to take advantage of pre-existing external economies and inter-trade dependencies. Moreover the SMEs that formed, although not clustering as they do in the West, did to some extent co-operate with each other to improve their survival. This type of co-operation was often found to exist amongst the new *fermerskie* farmers and was more ubiquitous in Rostov oblast than it was in other regions of Russia (Brooks et al, 1994, 1996). This co-operation was mostly for input supply, marketing, use of machinery, provision and receipt of credit and in the use of consulting services rather than for food-processing (Brooks et al, 1994). One



economics institute<sup>33</sup> in Rostov oblast however found that small peasant farmers were co-operating together to establish one or more food-processing plants,<sup>34</sup> a trend that has also been corroborated by another source of literature (Wegren, 2000). This form of co-operation even in Rostov oblast was not widespread throughout the whole region and was often conducted on a very small-scale involving on average just five to eight 'fermerskie' farmers<sup>35</sup> (Tarasov, 1997a,b). Nonetheless it provided fermerskie farmers with a vital survival tool to combat size disadvantages, obtain economies of scale and pool transaction costs in marketing within a market used to dealing with large players (Kuznetsov and Markin, 1997; Tarasov, 1997a,b). As this form of co-operation appeared mostly in the agricultural sector, one could infer that it was built on earlier models of co-operation (the mir or obshchina see chapter four and the Tsarist era). Irrespective of the traditions that may have prompted this form of co-operation there was no evidence that in the post-Soviet period it was leading to innovation in production or marketing as it might in the West.

One way to understand what was affecting the development of SMEs in food-processing is to analyse what happened to the food sector in general during transformation, to understand the way opportunities and constraints in the economic environment were shaping it.

## 6.4.2 The Effects of Transformation on the Food Industry

This section uses statistics to analyse what happened to industry in general and especially to the food industry in Russia compared to Rostov oblast during transformation in the 1990s. Transformation had a largely negative effect on the food industry. As already stated it caused a fall in agricultural output, input costs increased to world market levels, monopsonistic actions by the former state owned food-processing enterprises, border protection between the regions against domestic



food trade and a fall in state procurement levels. Although these problems hit all downstream and upstream sectors of the food industry harshly in Russia, they were arguably less severe than in many other consumer sectors.

The difficult agricultural situation and a population increasingly dependent on food self-sufficiency had a largely negative impact on the output of the food-processing sector. For example in Russia most milk and meat processors reduced output by 70%, and it was estimated that this meant milk processors worked at 30-50% of capacity and meat processors at 25-45% (Goncharov, 1998). Although output of food processing fell, this sector did not suffer such large falls as other manufacturing industries and remained amongst the top five industrial sectors during the 1990s in Russia (Ioffe, 2001). Moreover, in the second half of the 1990s unlike most manufacturing industries some sectors of food-processing (mineral water production, potato products) started to experience a slight recovery, especially if they were located in major urban areas (Ioffe, 2001). For example during the first half of 1999 domestic beer production increased by 33%, which made it the fastest growing industrial sector in the Russian Republic (Russian Regional Report vol 4, no 42, 10/11/99). The improvements to output after 1998 in the food-processing sector reflected the special qualities that the food sector had, in that unlike other consumer goods it was a product normally paid for in cash which helped with cash flow, the economic cycle was shorter and capital turnover was more dynamic. Also cheap imports had alarmed domestic processors sufficiently to encourage them to become more efficient and creative.

At the regional scale table 6.4 shows that although the share of the food industry in Rostov oblast had declined over the years from 1990-1996 it still occupied an important position in the oblast's industrial production. After August 1998 its share in the output of industry must have improved somewhat, as the food industry



was one of the first industrial sectors to experience an increase in production levels (Bakeev, October 1998). The weak rouble effectively opened up a window of opportunity enabling Rostov's food products to compete with what became highly priced imports (Bakeev, October 1998)<sup>36</sup>.

<b>Table 6.4 The Branch Structure of Industrial production for 1990-1996 as a % of the Total within Rostov Oblast</b>							
Industry	1990	1991	1992	1993	1994	1995	1996
Rostov Oblast	100	100	100	100	100	100	100
Including:-							
Electro Energy	2.8	3.3	7.7	8.8	12.1	15.6	24.2
Fuel Industry	8.5	4.5	10.1	8.9	14	17.5	17.6
Ferrous Metals	4	4.2	9.4	8.1	6.2	8.3	7.3
Non Ferrous Metals	3.6	4.4	5.2	5.2	4.4	5	2.7
Chemicals and Oil Chemicals	7.5	8.2	7.7	6.4	5.9	4.2	3
Machine Building and Manufacturing	35.5	31.1	27.5	27.8	26.3	21.5	19.1
Woodprocessing and Cellulose Paper Processing	2.8	3.1	2.1	2.4	1.9	1.7	1.6
Construction Materials	3.3	3.4	3.3	4.4	5.3	5.1	4.2
Light Industry	10.3	13.9	7.7	5.3	3.5	2.7	1.7
Food Industry	18.2	20.4	16.3	20.4	18.5	16.7	16.4

(SOURCE Goskomstat Rossii Rostovskoi oblastnoi gosudarstvennoi statistiki, Rostov na Donu, 1997a)

The potential of the food industry in Russia was acknowledged by investment from some newly established banks that had formed financial industrial groups (FIGs)<sup>37</sup>. Although agriculture was a particularly high risk investment sector because of its poor financial record and access to subsidies (Brooks et al, 1996; OECD, 1998)<sup>38</sup> large FIGs like Alfabank and Menatep were investing in both it and processing firms. Interest from FIGs was especially strong in highly profitable sub-sectors such as sunflower production and processing (Schleifer, 1997). Such bank interest was also apparent in Rostov oblast, though it came from local banks rather than the big Moscow banks and was mainly in food-processing rather than agriculture. For example Doninvest (one of the largest banks in the region) had controlling shares in about 300 enterprises of varying sectors. In the food industry this included OAO Rostovskii molkombinat, OAO Tselinksii cheese factory, OAO Azovskii konservnyi babyfood bombine, Rostov konditery (Tarasov and Maksutova, 1997c), and also tobacco, confectionery, macaroni factories (as well as those



factories providing agricultural machinery such as Taganrog combine, and Krasnyi Aksai cultivator) (Kusnetsov and Markin, et al, 1997). Although this bank interest was a positive move providing access to finance, it was limited to former state-owned enterprises and not extended to newly founded SMEs. In addition these former state-owned enterprises were in some of the most lucrative food sectors and were already established monopolies; so unless regulation improves barriers could develop in the future that would prevent new SMEs entering these sectors.

Large firms from any sector including food processing were also creating their own 'FIGs' to support production (this was based on ownership rather than proximity). In Rostov oblast the gas industry FIG Gasprom invested in some of the most profitable sectors of agriculture (Serova, 1999a; Informant 9). Other FIGs were similar to those that existed in Tsarist Russia and those that came into existence in Soviet Russia in the 1960's like 'Rostov combine khlebprodukt' and which still existed in the 1990s, and included such enterprises as 'Donkhlebprodukt', 'Mechetinskii elevator', and 'Sernogradskii elevator' (Tarasov and Maksutova, 1997). Some corporate investments in Rostov oblast's food industry came from smaller regionally based companies like the Rostov trading company Priroda, which together with Donkombank bought a controlling stake in the Kamenskaya confectionery factory<sup>39</sup> (Gorod N, no 44, 4-10 Nov, 1998).

These new kinds of relationships were symptomatic of an economic environment where transaction costs were high for accessing finance and information. This could have indicated that the market was becoming even more monopolised. This however, only explained the situation in the formal economy and not the informal economy, which in Russia remained particularly important for SMEs in the 1990s.



### 6.4.3 The Continuing Importance of the Informal Economy

The informal or second economy remained an important feature in the post-Soviet period<sup>40</sup>. In theory it can be beneficial, because the informal economy temporarily shelters business owners from high transaction costs enabling them to launch and develop their activities before transferring to the formal economy (Guariglia and Byung, 2001, Levenson and Maloney, 1998). The fact that the informal economy continued to grow substantially in Russia during the 1990s suggests that new firms were not transferring into the formal economy. Instead they preferred to stay in the informal economy and to remain invisible to state regulations for reasons already discussed above.

Although it was not possible to determine from statistics how important the informal economy was for the Russian economy (or Rostov oblast specifically), its size was generally considered to be more substantial than it was during the Soviet period<sup>41</sup>. One study estimated that the informal economy grew from 12% of GDP in 1989 to 41.6% in 1995 (Guariglia and Byung, 2001)<sup>42</sup>. As discussed in section 6.3.2 on Economic Policy the assumption that there would be a wholesale transfer of many firms from the informal economy to the official economy, once the law was changed to allow free enterprise, was not borne out.

For new SMEs the informal economy effectively became the norm for start up, while high transaction costs characteristic of the formal economic environment made it hard for them to move out of it. The skills that enterprises both large and small developed during the Soviet period, specifically for dealing with constant shortage and reaction against state regulations, contributed to creating an anti-state stance and a preference for informal working. So much so that resistance to



government measures prevailed in the business culture of the 1990s (Hood et al, 1997). Firms would only transfer to the formal economy if there were some advantage for doing so, but during the 1990s the formal economy offered few advantages to independent small firms whatever their activity. This will become evident in the discussion below analysing access to and availability of the various factors of production.

#### 6.4.4 The Availability of the Factors of Production

One of the important issues highlighted in the conceptual framework, which can encourage formation of SMEs, is access to all the factors of production. In Russia during the 1990s access to factors of production (land, labour, raw materials and finance) was made difficult by a dearth of information. Many SMEs were forced to rely on informal contacts, but they also used other sources such as newspapers and the internet. Few SMEs used specialist information or business centres (Russian SME Resource Centre, 2001). This may have been because such agencies were relatively new and the information was of low quality, or more likely it was due to distrust of any state controlled support centre. The sections below discuss how access to a variety of factors of production may have influenced the pace of SME formation. The first factor is access to land and premises and the protection of basic property rights

The availability of agricultural land for new industrial uses was restricted in Russia by the re-organisational process and by the state forbidding a change of land use<sup>43</sup>. As most small food-processing firms were more likely to be located close to areas of consumption (to take advantage of market access and transport) access to agricultural land in rural locations was unlikely to be an issue for them. More important was land availability in urban areas. Unlike rural areas, in urban districts



there was usually a surplus of unused factory and social premises in former state-owned enterprises, such as canteens and kindergartens that could be leased to small businesses. Some regional authorities apparently disapproved of the lease of what had been state-owned property<sup>44</sup>, though in Rostov region there was no evidence that this had created difficulties for SMEs. Data from interviews indicated that it became easier throughout the 1990s to find suitable premises. Certainly the businesses interviewed expressed no problems with the premises they leased, nor in finding them. For instance one small bakery was located in a former school building with access to running water and electricity (Informant 7). Although all the premises had been inspected by the authorities and were said to conform to regional hygiene regulations and all had access to basic utilities, to a western researcher they seemed unhygienic for the food-processing tasks that were taking place. The baker, despite claiming to have no problems with the premises, did express that had he owned them, he would have renovated them to make them more suited to baking.

Although the property market was imperfect as a result of information gaps it was, according to the experience of SMEs in Rostov oblast, relatively easy to lease premises. The main problem was not leasing but with property rights and ownership. By the winter of 1998 land ownership with full property rights had still not been passed into law<sup>45</sup>, despite the 1993 constitution and article 17 of the civil code which allowed for it in theory. This was partly because the sale and ownership of agricultural land was such a contentious issue that it slowed down the adoption of a law guaranteeing general land ownership (of both urban<sup>46</sup> and rural land<sup>47</sup>.) (Economist, 9<sup>th</sup> March 2001). Consequently a comprehensive land code, which determines mortgage rights, land use, sale and inheritance had still not reached the statute book by 2000. The result was that in most regions, land to build a house or dacha only became available through bribes, and this did not create sufficient incentives for local bureaucrats to hurry their decision to allow for the lawful selling of



land for industrial uses. Even when there was a change to the law in 2001 and 2002, regional governors were allowed to interpret the new land codes as they wished, which meant that there was still no standard national procedure, and land sales could be prevented (The Economist, 9<sup>th</sup> March 2001).

Lack of legislation protecting land ownership and property rights (in the land reform legislation (Ericson, 1997)) has meant that during the 1990s banks still did not accept mortgaging (in other words lending guaranteed by property)<sup>48</sup>. This was because there was little legal protection of private property from government confiscation<sup>49</sup>. In St. Petersburg this lack of legal protection was causing so much uncertainty and damaging the development of private business that the city took measures to prevent local government agencies from confiscating property (Ericson, 1997). Unfortunately this regional solution was not translated into national practice. St. Petersburg though is different to Rostov-on-Don (the capital of Rostov region), with property selling at high prices due to the huge demand for it. Rostov-on-Don on the other hand is a provincial capital city, and had not yet attracted the attention of large foreign institutional investors, so demand for its land was not as great. Nonetheless the lack ownership rights caused problems with obtaining mortgage finance for both farmers and urban based food-processing firms in Rostov region, and was why the food-processing firms interviewed were forced to rely on international organisations for finance.

What was happening in Russia during the 1990s tends to support the impression that culturally the idea of property ownership, in particular over land and buildings, was not accepted in general or specifically by state officials (Ericson, 1997). Consequently it left small businesses insecure and uncertain about their right to develop property, to use property as the basis for raising capital, or the idea that



property was a bequeathable asset, conditions taken for granted in western market economies.

Land though is not the only property right, other property rights were also supposed to be protected in the 1993 civil code, though the widespread phenomenon of rent seeking and the demands of mafiya type criminal organisations suggest this was not so. Despite these problems with property rights, evidence from newspaper reports suggested that on the whole property rights were much better protected than they had been during the Soviet period. This view changed dramatically at the end of 2003 when the oligarch Khodorkovsky was arrested for tax evasion and fraud. The state was now seen as becoming even more powerful than it had been; The Moscow Times reported that any business could potentially have “its property seized, its profits squeezed and its people prosecuted as criminals” (The Moscow Times, 25<sup>th</sup> December 2003). The law consequently appeared powerless to protect individuals and businesses against such behaviour from the state. Moreover this state act meant that the state was doing little to reduce transaction costs. Only those businesses that were weak were unlikely to be threatened by this new situation (The Moscow Times, 16<sup>th</sup> September 2004). Consequently property rights in Russia continued to remain insecure, and this adversely affected the incentives for potential SME owners to engage with the entrepreneurial process. Another less contentious factor of production was the employment of appropriately trained employees.

From interviews conducted in Autumn 1998, SME owners said that they experienced few problems in obtaining the trained labour they needed. They put this down to the prompt payment of much higher wages than the former state-owned sector, where pay was not only lower but often delayed by many months. The SME owners interviewed during the course of the field trips to Rostov oblast had found labour by a variety of methods. One small business owner had personal contacts



with a labour exchange agency (Informant 5). Another SME owner used information from personal friends to find appropriately trained labour (Informant 7). These and other informal methods of finding employees were strategies used throughout Russia according to a report published in 2001 by the Russian SME Resource Centre<sup>50</sup>. Generally SMEs found that informal methods of finding employees were sufficiently effective not just for finding unskilled labour, but for specially trained labour. Some SMEs might have experienced problems in finding labour if large firms (despite not paying wages on time) provided good and valuable social services of the kind inherited from the Soviet period<sup>51</sup>.

Smaller firms during the 1990s then were not necessarily at a disadvantage in the labour market, and this appeared to be the case with the SMEs interviewed in Rostov oblast. The same may not be true in other labour markets (for example in Moscow) or other sectors (for example in technology based sectors). Though given the generally high level of unemployment and underemployment in Russia, it may be fair to infer that the transaction costs surrounding labour recruitment and retention were not too high for SMEs in Russia compared with the cost of retaining labour in large former state-owned enterprises. This was an area where SMEs, because of their flexibility and operation in the informal economy (freeing them from labour regulations) could exercise a comparative advantage, though this may have left employees vulnerable to insufficient regulatory protection. SMEs though were not just concerned about access to labour, one of the biggest problems they had was in sourcing and finding material inputs.

Small business in Russia during the 1990s were characterised as having their development constrained by the difficulties they experienced in accessing inputs. (Easter et al, 1998). Chapter five on the Soviet period detailed how the old system was geared up to supplying large amounts of material inputs to enterprises. In the



post-Soviet period small firms did not need such large quantities and this created difficulties when trying to use the former state-owned sector as suppliers (see also section 6.3.2 on Economic Policy). At the same time the new private 'fermerskie' farms not only lacked sufficient land to provide commercial quantities of raw materials to small processing firms, they also tended to have insufficient marketing links through which to sell their output<sup>52</sup>. In other words small firms had to operate in an imperfect market, where information was difficult to obtain and which contributed to high transaction costs for sourcing raw materials. It was not just access to raw materials that was difficult for small firms; access to finance was as indicated above extremely problematic.

Access to long and short-term finance for new and existing SMEs remained difficult throughout the 1990s. It became even more acute when the bureaucratic cost of starting a business rose substantially in 1995. The finance that small firms used in Russia during the 1990s came from a variety of sources. The most important was self finance, borrowing from friends and family as well as re-investment of profits (also found in Poland and the Baltic states see Smallbone et al, 1995b, 1996a,c). The second most important source was bank finance, though this remained minor due to a variety of problems discussed below. Other sources were the state and also international organisations.

In the early 1990s the banks that existed were those inherited from the Soviet period such as *sberbank* (the savings bank), *promstroibank* (industry bank), *agroprom* bank (agro-industry bank)<sup>53</sup>. Initially these continued to act as they had in the Soviet period serving large enterprises and ignoring the small firm sector (Easter et al, 1998). Although new banks were also being set up, they too predominantly served the needs of large enterprises. Small businesses were seen as too much of a risk, they had limited property rights and in a country where the judicial and



enforcement procedures were weak banks appeared to have little option but to refuse them loans. Russia then had not developed adequate formal institutions that would have provided sufficient protection for both banks and SMEs and that would have also encouraged both parties to develop mutually beneficial business relationships.

It was only when the financial market became saturated with banks in 1995 that the small business sector was considered a viable potential new customer. The banks though were very selective and chose to work predominantly with the highly profitable trade sector rather than manufacturing (Easter et al, 1998). In Rostov oblast some commercial banks began to look at the agro-industrial complex. They were particularly interested in the profitable small firms specialising in the production of grain and sunflower seeds, or processing such products as groats, sunflower oil, flour, as well as certain types of meat and milk products (Zolotarev et al, 1995). Russian banks, however, were not secure financial institutions and the banking crisis in 1995 and the currency crisis in 1998 caused many businesses to lose their bank accounts and money. Consequently it was common for small businesses to protect their money by holding accounts in a variety of banks, by using the informal economy or by investing in such commodities as gold (Dolgopyatova, 1997; Humphrey, 2002).

The poor state of banking in Russia was a serious problem, especially as the economy was predominantly cash based (Humphrey, 2002). SMEs overall found it difficult to obtain loans, and even when they were available, the loan period was too short and interest rates were so high they were unaffordable. Most SMEs in Russia survived by re-investing their profits, or by using the owners personal savings (Easter et al, 1998) and avoiding such business practices as inter-enterprise debt or credit, which would have restricted their cash flow. Consequently developing a small business and seeking out opportunities was restricted by shortages of finance.



The only other credible source of finance for SMEs in Rostov was from organisations such as international aid agencies<sup>54</sup> (Informants 5, 7 and 10). The success of these organisations in obtaining funds from international agencies was rather unusual according to research undertaken by Easter et al (1998), for evidence nationally suggested even fewer received them than from the state. Rather, this result reflects the fact that contacts with informants in Rostov oblast were only available through international organisations.

This section has shown that in several important areas (finding land, premises, securing property rights for it, sourcing raw materials and securing start up finance and working capital) the relevant formal markets in Russia were characterised by high transaction costs. Only in areas of labour recruitment and retention did new small firms appear to be at no significant disadvantage compared to large firms. To a large extent transaction costs were high in most factor markets because of the dearth of information and the personalised nature of many transactions. In Rostov as in other parts of Russia, small firms lacked information not just on the procedure to set up a new firm, but on relevant laws and regulations and subsequent changes to them. Although lack of information was affecting both large and small firms it was arguably more damaging to small firms because they had fewer contacts<sup>55</sup>, and because their survival was more dependent on the market rather than subsidies. Small firms could have obtained information from private consultants, but there was no guarantee about the quality of the information, and any information the small firm provided was not sufficiently protected to prevent it from being transferred to tax inspectors or criminal structures (Chokh, 1997). If the formal economy was unable to provide sufficient access to factors of production then the only other option was the informal economy, though even here uncertainties existed and long-term development was likely to be compromised.



Apart from the factors of production small business needed demand for its products. The next section analyses the potential for demand in the food market and the opportunities that existed for small food-processing enterprises.

### 6.4.5 Wages, Prices and the Consumer Market

From the beginning of transformation in January 1992 inflation, following price liberalisation and the fall in consumer subsidies, had a detrimental effect on real income levels and on demand as the payment ability of the population lessened (especially for products with a high income elasticity of demand such as meat) (Serova, 1999a; Gros and Steinberg, 1995). In 1990 before transition began, the average income level in Rostov was 96.4% of the average income in Russia, by 1995 this had fallen to 64% (Vysokov, 1997). To obtain some idea of what this meant in 1997 Rostov inhabitants had about 80% less disposable income than inhabitants in Moscow<sup>56</sup> (Vysokov, 1997). In other words compared to many regions Rostov citizens were becoming generally more poor. One of the reasons why income levels were so low was because levels of unemployment in Rostov region were higher than the national average (contrary to expectations, considering the varied industrial structure), contributing to more people living on static incomes. According to statistics in 1995 the percentage of unemployed in Rostov oblast was officially 8.1% compared with the then Russian average of 7.9% (Vysokov, 1997). In 1996 this had increased to 8.6% (Goskomstat Rossii, 1997b).

From 1992 most regions including Rostov oblast experienced huge differentials in the income levels of its population, which created a new rich and a new poor. This income polarisation affected demand for food as the poor increasingly became more self-sufficient (Gustafson, 1999)<sup>57</sup> and decreased demand for cheap products, whilst the rich increased consumption of more expensive



products. This change in demand promoted a structural change in the output of the food industry from 1993 (Frenkel', 1998). For example although whole milk production fell in Russia by 17% the output of cream increased by one third. Another example shows that general meat production was decreasing at the same time that the production of some hard sausage goods (luxury items) was increasing.

The following table (6.5) shows the ability of the average income in Rostov oblast to purchase basic food products in the first half of the 1990s. This table indicates a consistent decrease in the food purchasing ability of the population in Rostov region between 1990-1996. For example for flour, margarine and cabbage

Table 6.5. The Purchasing Ability by Average Income in Rostov Oblast 1990-96							
Number of products which can be purchased by the average persons monetary income in a month	1990	1991	1992	1993	1994	1995	1996
Wheat bread from flour sort 1+2 (kg)	578	573	537	416	275	524	189
Beef (kg)	50	45	36	27	47	41	46
Milk (litres)	770	828	500	313	232	181	199
Animal Fat (kg)	58	56	15	22	26	20	27
Eggs	1891	1490	1049	967	1002	1010	1058
Fresh Fish (kg)	132	103	91	65	58	65	70
Granulated Sugar (kg)	234	173	40	79	141	100	146
Margarine (kg)	133	167	43	50	50	37	49
Vegetable Oil (kg)	95	106	86	84	98	62	91
Rice (kg)	260	242	118	184	216	119	124
Potatoes (kg)	325	209	270	332	279	168	235
Cabbage (kg)	594	285	388	265	195	246	216
Apples (kg)	118	115	118	147	118	90	105

(SOURCE Goskomstat Rossii, 1997a)

the ability of the average income to purchase these products fell by over 50%. In Rostov after the devaluation of the rouble in 1998, the average income was able to purchase fewer products<sup>58</sup> as a result of increased prices<sup>59</sup> and this caused the consumer purchasing ability to fall by 10-20% in August 1998 compared to August 1997 (Molot, 27 October, 1998). Increased prices after devaluation sometimes reflected that many domestic producers used imported inputs. In Rostov oblast



many producers did not use imported inputs, instead devaluation decreased their production costs, which enabled them to keep prices at the same level whilst still making a profit. For example the Rostov milk combine did not increase prices and still made a 3% profit during 1998 (Bakeev, September 1998; Vel'yaminov, 1998).

During transition most prices increased substantially. In Rostov oblast by the end of January 1992 the average increase in the retail price of foodstuffs compared to December 1991 was 2.8 times and this was even with some price controls (Goskomstat Rossiiskoi Federatsii, 1993)<sup>60</sup>. The following table will provide some indication of the phenomenal size of the price increases for basic food products in Rostov region.

Table 6.6 Retail Prices for Basic Foodstuffs in Rostov Oblast as a Percentage of the Previous Year			
	1991 as % of 1990	1992 as % of 1991	1 <sup>st</sup> 6 months 1993 in % to 1 <sup>st</sup> 6 months 1992
Meat and Poultry	337.6	1232.5	866.5
Milk and Milk Products	216.5	1617.9	610.8
Vegetables	343.9	673.1	450.1
Fruit	207.2	1059.9	429.6
Eggs	294.7	994.3	906.6

(SOURCE Goskomstat Rossiiskoi Federatsii, 1993)

From table 6.6 it is evident that the prices of animal products increased faster than for non-animal foods. A good illustration of what this meant for the food industry is to take two very different products – meat and bread, where meat is generally more expensive than bread.

Table 6.7 provides statistics on the consumption of meat and bread products in three blocks. One shows the figures for the average consumption levels from all regions in the Russian Federation. The second block of figures is based on consumption levels in Moscow oblast. Moscow oblast contains the capital city



Moscow, and consequently is a higher income region<sup>61</sup> than Rostov oblast, which is featured in the final block of consumption figures<sup>62</sup>.

Table 6.7 Levels of Consumption for Two Basic Food Products												
Per Head of Population (kg)	Russia				Moscow Oblast				Rostov Oblast			
	1990	1994	1995	1996	1990	1994	1995	1996	1990	1994	1994	1996
Meat	75	57	55	55	59	59	59		76	49	44	40
Bread and Bread Products	119	124	121	117	106	105	101		121	124	131	125

(SOURCE Ministerstvo sel'skogo khozyaistva i prodovol'stviya Rossiiskoi Federatsii, part 1, 1998)

Looking at the figures for the Russian Federation as a whole, consumption of meat products fell dramatically from 75 kg per head of the population in 1990 to 55 kg in 1996. For bread products this figure initially rose from 119 kg in 1990 to 124 kg in 1994 before falling slightly to 117 kg in 1996. The fall in consumption was far greater for meat than for bread products, indicating the existence of better opportunities for SMEs in baking than in the meat industry. The statistics for Moscow oblast show an entirely different situation, here incomes tended to be higher than the national average and seem to account for why the consumption for both products was relatively stable. At the opposite end of the spectrum is Rostov oblast. Here the fall in the consumption of meat products before transition in 1990 to 1996 has been much greater than for Russia on average, despite its consumption in 1990 being slightly higher. The statistics for bread products reveal an increase in their consumption, which only fell slightly in 1996, though it was still at a higher per capita level than it was in 1990. Looking at the ability of the population to afford certain products (and the important role for bread in the Russian diet) it was hardly surprising that the most common form of small food-processing occurring throughout Russia including Rostov oblast was baking.

One reaction of some regions to the fall in demand (due to the worsening ability of its population to afford food products) was to give out coupons or talons to



certain sections of society for the purchase of certain basic goods. The problem with these coupons was that they were specifically for products from large rather than small enterprises, and were in effect a kind of subsidy that created an unfair competitive environment that kept inefficient large firms operating (Humphrey, 2002). So not only did small food-processing firms have to cope in an economic environment where demand was falling they had to deal with another state devised barrier in the consumer market for their food products, which increased their financial risk.

During the 1990s demand for food products fell in Rostov oblast in response to a combination of falling real incomes, rising unemployment and rising prices. This global statement though conceals the changes to demand in response to a polarisation of income, where there were both extremes of wealth and poverty. In Rostov oblast where import penetration of food products was low, domestic producers became the foremost important suppliers of both luxury and basic food products. Consequently opportunities existed in Rostov oblast for all local food processing firms including SMEs, despite the harshness of the economic environment. Moreover when problems in the economic environment were temporarily hidden, as a result of devaluation in 1998, local food processing firms of all sizes were not just capable but also seized the opportunity to supply the local market.

#### 6.4.6 The Role of Transaction Costs in the Economic Environment

The economic environment as depicted above was not conducive to encouraging new SME formations or the further development of existing SMEs. One way to fully understand how constraints in the formal economy impacted on SME activity is to



examine the role of transaction costs, which have already been alluded to in the above analysis. The conclusion that has to be drawn is that not only were transaction costs high but the state did little to reduce them. Moreover, unlike the former state-owned sector, SMEs were unable to internalise these transaction costs because they lacked the wide networks of contacts the former state enterprises had through the *tolkach* system, and they were unable to provide inter-enterprise credit.

To survive in the formal economy many small firms, like those interviewed in Rostov oblast found ways to circumvent imperfect and costly factor markets and state regulations. Apart from operating partly in the informal economy, where it was possible to avoid some of the most pernicious regulations and legislation, most SMEs developed their own personal networks. The problem with these personal networks was that they were smaller and this restricted exchange. Nonetheless personal exchange was useful when the judiciary and enforcement systems were inefficient and provided little real protection from opportunism. In other words a weak judicial system prevented a generalised inter-personal form of trust from developing that would have encouraged widespread arms-length exchange. The personalised forms of exchange that developed, by their nature, functioned on a more limited form of inter-personal trust, but the time and effort that went into conducting this form of exchange meant that transaction costs though lower were still high. So although the risk of opportunism was reduced significantly transaction costs remained high enough to limit or even prevent production and exchange, and this meant that the opportunities that were available would have been overlooked or not exploited fully.

It is the duty of the state to reduce transaction costs, but the federal and regional state in Russia did little to reduce transaction costs for SMEs in general or for the food industry. Firstly the widespread existence of personalised exchange reduced the pressure to improve company law. Secondly the state failed to create



and implement an adequately financed and well-designed SME policy that would compensate SMEs for their size disadvantages in a market dominated by monopolistic large firms. Instead transaction costs remained high because of an insufficient agricultural procurement system, but they were also increased by state officials because of the arbitrary manner they implemented support programmes, registration and legislation. Consequently the state, by not being reliable or consistent in its help to SMEs, negatively affected the way the opportunity structure was perceived in the formal economy. More importantly it left SMEs vulnerable to the opportunistic rent seeking demands of bureaucrats but also to the demands of criminal groups, which saw a way of exploiting the situation by offering protection from an over zealous officialdom. The state consequently helped to create an economic environment with high transaction costs that was not welcoming to new entrants nor to the further development of SME activity.

The political and economic environments on their own do not provide a sufficiently full explanation for the difficulties of SME formation and development during the 1990s. To adequately appreciate why opportunities were and were not being exploited by SMEs it is necessary to examine the ways in which the social and cultural environment influenced entrepreneurship and entrepreneurial activity.

## **6.5 The Socio-Cultural Environment**

Transition is not just shaping political and economic change it is also affecting social relations. The conceptual framework highlights the importance of understanding how society influences the business sphere, firstly through attitudes towards business and secondly through the social groups that exist and engage in SME activity. Social change generally occurs more slowly than political and economic change; and this



was the case in Russia, despite the sudden abandonment of the principals of Marxism-Leninism, which had previously guided society. From 1992 Russian society has had to adapt to a political environment with democracy and an economic environment that operates under capitalist or market type principals.

In the business sphere the ethics (of the Soviet period) that had guided conduct both in the official economy (between state-owned enterprises) and the informal economy were unlikely to be suited in a market type environment. Moreover, although the economic and political environments had changed radically, the shared understandings and knowledge of members of society (which create the 'informal institutions') had not. This meant that the old ways of conducting business, business ethics and the old Soviet style relationships were likely to persist, but would also be incompatible with the market. If (as chapter five demonstrated) Soviet Russians were entrepreneurial and used their entrepreneurial talents to circumvent the system, then it seems likely that this kind of entrepreneurship would be inherited into post-Soviet Russia.

The most damaging feature in the social environment during the 1990s was the emergence of a distinct social polarisation or widening gap between the poor and the rich, something that had been absent in Russia for the best part of a century. According to a report by Wadham (1999) more than one in three Russians lived below the poverty line and 35% of the Russian population (51.7 mn) had monthly salaries that were below the minimum subsistence level of 872 roubles (\$36) in the first half of 1999<sup>63</sup>. This figure may have over-exaggerated the level of poverty because it ignored income earned in the informal economy, but it nonetheless reflected the loss of social solidarity that had typified Soviet society. In addition high rates of poverty in a society restrict mass consumption, which affects the development of all industry including SMEs, and implies that a significant section of



society does not have the resources or access to resources to venture into business creation. In addition extreme income polarisation may generate resentment and social tension that could damage the acceptance of the market economy, private enterprise and business success.

Change to the socio-cultural environment was not just restricted to the loss of social security it also included the emergence of civil society. In the Soviet period civil society in the western sense of the term did not exist. According to Fukuyama (1995), civil society and the formation of NGOs creates opportunities for the development of social capital (which in the broad sense creates a form of social inclusion, which is more likely to encourage admiration of rather than hostility towards business success). The post-Soviet state appreciated the positive effects that a strong civil society could have and attempted to encourage it through legislation and by supporting some NGOs. Civil society by its nature is independent of the state, is impossible to create artificially by legislation and develops spontaneously over time as non-kinship trust based relationships are formed. In Russia during the 1990s civil society had not had sufficient time to develop. A poll conducted during 2001 showed that out of 1500 people throughout Russia just 5% participated in NGOs, which confirmed that only a small proportion of the population were engaging in civil society (Bashkirova, 2000). This poll may have reflected a certain amount of apathy, but it also indicated there was a lack of confidence in NGOs. This was because many were believed to have been formed by powerful cliques for their own purposes, used state funds and were considered ineffective (Richter, 1997). This low level of involvement in NGOs does not generate much experience of non-kinship or generalised interpersonal trust based relationships, which may have important negative implications for the future development of SMEs (in other words will contribute to low formation rates and limited SME activity). Moreover, the importance of wealth and cash in the new market economy has begun to depersonalise



relationships in the old Soviet informal networks by disconnecting those without sufficient financial means (Frisby, 1998).

The low participation rate in NGOs in the 1990s suggested that the socio-cultural environment had not changed sufficiently to encourage people to engage with the entrepreneurial process and set up small firms. But there has been some change and an important one was to social groups. The next section examines whether transformation of the social environment has created new sources of supply for entrepreneurship in Russia capable of forming and developing SMEs.

### 6.5.1 Social Groups

The change to social groups in Russia had only just begun in the 1990s (and remains on going) which makes analysing what this meant for SME formation difficult. What has become clear is that unlike in the Tsarist and Soviet periods, the state did not use ideology to impose social groupings or classes, rather the formation of new social groups was a bottom up process driven by economic change (Humphrey, 2002). In the 1990s the old social groups from the Soviet period still existed for example the white and blue collar workers, the peasants and the bureaucrats, but they were supplemented by new ones based on wealth rather than occupation, for example the 'new rich' and the 'new poor'. The question is from which social group will future small business owners emerge?

One of the most well known new social groups in Russia during the 1990s was the 'new rich'. Some of the rich in this category became known in the Russian media as the 'robber barons' or the 'oligarchs' and included such individuals like Abramovich and Beresovsky. They were often young middle-aged individuals who understood the operation of the Soviet economy, and had had positions of influence



within it<sup>64</sup>. They were also young enough to adapt to the changes that occurred in the 1990s, and were able to use their positions of power to gain ownership or control of some of Russia's most valuable assets. Many of them became the new owners of privatised large industrial enterprises and assets in such sectors as oil and gas and metals and who have been and to some extent continue to be politically influential.

The members of this group during the 1990s showed no evidence of setting up small firms in Russia, either by direct intervention of their personal wealth or indirectly by funding venture capital initiatives. This group preferred industries that generated huge profits without high risk, but yet offered a chance to operate on world markets. Members of this group were more likely to have offshore bank accounts and buy property in foreign countries than they were to invest in a small firm. What was particularly concerning was not only that profits were not invested in Russia, but they were used to buy imported luxuries or were spent outside Russia, so even indirectly they did not stimulate opportunities for domestic industry including SMEs (Braguinsky and Yavlinsky, 2000). Generally members of this group have been unpopular in Russia, partly because the old Soviet tradition of egalitarianism has lingered on, and partly because the origins of their wealth was associated with corruption (Kon, 1996). Consequently although they were successful in the 1990s they were not widely admired, moreover, even if younger generations were attracted to their life-styles their business dealings followed the principle of 'get rich' at any cost or 'everyone for oneself' (Kon, 1996). Consequently members of this group were not the kind of role models that were needed for building a wealth creating market economy. What was needed in Russia was a middle class, which in the West has been closely associated with supporting democracy and entrepreneurship.

According to some sociological experts<sup>65</sup> a middle class was emerging in Russia during the 1990s, though it was small containing around just 10% of the



population (see Maleva undated internet article; and Blazhenkova and Gurova, 2000)<sup>66</sup>. Other experts considered that the existence of the middle class in Russia has not only been exaggerated, but that it was and remains difficult to define because it was not an homogenous group (Klimova, 2004). Although debates over defining the Russian middle class are ongoing, the various articles used for this study have contributed to providing a brief description of its budding membership in the 1990s and helped to draw some conclusions about the potential of its members to invest in SMEs. Most articles about the middle class in Russia depicted its members as having a certain income level, a university education and professional status for example some had already set up SMEs, worked in private sector management or were specialists (Businessweek, 16<sup>th</sup> October, 2000; Blazhenkova and Gurova, 2000; Klimova, 2004). The main attribute of this class, in contradistinction to the oligarchs and the 'new rich', was that they were more ready to invest in Russia. For example SME owners have re-invested their profits (Businessweek Online, 16<sup>th</sup> October 2000), and some managers of former state-owned firms, for example the manager of Tarv a meat processing firm in Rostov oblast, have invested in and developed an already existing businesses. Although investment in Russia was understood as a specific attribute of this group, one report suggested that the majority remained extremely cautious in the 1990s, and preferred prestige in business management or the bureaucracy to independence in the more risky SME sector (Burdeau, 2001). Consequently it may be some time before many of this class's membership become entrepreneurs and bring about a significant increase in the number of SME formations.

A potential or proto middle class was also said to exist in Russia. This section of society may provide a future supply of entrepreneurs, but in the 1990s they either did not have the wealth, or they did not have the professional status and skills to do so. Those without the wealth but with the skills and education included,



teachers, researchers, engineers, highly skilled workers and farmers (Burdeau, 2001)<sup>67</sup>. These people were generally still admired in society, and were well placed to become admirable future role models and SME entrepreneurs, when access to affordable finance improves. Those with the wealth included, stockbrokers, commodity traders, computer specialists, private hotel owners, bankers' mafiosi, prostitutes and taxis drivers (Blazhenkova and Gurova, 2000). They were not so widely admired, and like the oligarchs were considered to have obtained their wealth through speculation, which was no longer ideologically condemned by the state, but was still despised by the public. During the 1990s evidence suggested these members of the proto middle class were using their wealth to imitate the consumption patterns of the oligarchs and the 'new' rich, and consequently did not appear to show signs they would be good future role models and SME entrepreneurs (Blazhenkova and Gurova, 2000).

One group of individuals in the 1990s that had the potential to join the middle class, and were a potential future source of new firm entrepreneurs were the graduates that came out of business schools in the late 1990s. In Rostov oblast the educational establishments that provided such graduates were 'Institute for Management, Business and Law' and 'Rostov State Economic Academy'. Unlike graduates from these business and economic schools in the early 1990s and previously, students from the mid to late 1990s had received an education that incorporated an understanding of capitalism, the way it works, business ethics and so on. Nonetheless although such an education was important, the society they lived in did not operate to western economic models. Consequently their experiences of the transitional economy would inform the way they would operate in business, and this may not, or at least not initially, have translated into readiness to form an SME, or to conduct business along western models, though this did not necessarily account for their future actions.



The role models in Russia for potential entrepreneurs were successful business people like the oligarchs, but also those that had set up successful SMEs. The problem was that success in Russia was associated with corruption, trading on political influence and less than ethical business practices, rather than innovation or merit. In using the language of institutional economics the informal institutions inherited from the Soviet period were perpetuating negative assumptions about business, but they were also reinforced by the formal institutions that appeared to be pushing the new private sector into the informal economy. The whole situation was not helped by the absence of a tradition of family business, or by the lack of immigrant entrepreneurs who could engage in new firm creation. The danger is that the development of the market in the near future will continue to be distorted because the kinds of ethical principals that enable it to operate as it does in many western countries had not shown a on people to become small firm owners in any society is social attitude towards non-state business and wealth creation. The Soviet legacy of hostility towards speculation has been embedded into the psyche of the population for over 70 years and during the 1990s may have continued to act as an important social barrier to entrepreneurship.

### 6.5.2 The Cultural Environment and its Influence on Business Activity: the Role of Trust

Evidence from polls showed that social attitudes towards private business if not wealth in the 1990s had changed remarkably fast in Russia<sup>68</sup>. As early as 1992 one opinion poll conducted by the Russian Independent Institute showed that 80% of the people polled wished to establish a small firm (it remains unknown whether this was a fanciful wish or whether more concrete steps had been taken). These researchers concluded from this that there was no moral, social or psychological barrier to small firm development in Russia (Chepureenko, 1996). Some sociologists would not have



found these findings surprising, for they considered that the state had lost its moral superiority by the late 1980s and individuals had by then become more individualistic (Kon, 1996). Although there was no barrier to society's acceptance of the principal of private enterprise, there was some social hostility towards wealth and the trappings of success. It appears that in Soviet Russia by the late 1980s it had been more important psychologically not to let someone get materialistically ahead of oneself than it was to improve one's own wealth (Kon, 1996). In other words Soviet society was a sort of lose-lose society, where individuals were willing to suffer as long as everyone else suffered too. This may explain why the successful businessman or women was not publicly admired in Russia in the 1990s or held up as a role model.

Certainly the vilification of speculation in Soviet ideology and the huge polarisation of wealth in the 1990s contributed to hostile attitudes towards success. Surveys confirmed that economic egalitarianism remained important in the 1990s and this explained why price controls and state controlled limits on income were popular in public opinion polls. The implication from this was that some aspects of capitalism remained culturally unacceptable for large sections of the population (Christensen, 2000). In other words it perpetuated a negative attitude to success and successful small businesses (Chepurensko, 1997). This was also not helped by the lack of trust in successful business, and the general belief that success was only achievable with criminal or political connections, consequently it was not surprising that the apparently widespread aspiration to run a small business was not often followed up.

Corruption and dishonesty were not characteristics of independent business that first appeared during the post-Soviet period; they had been present in Russia's Soviet and Tsarist past. These negative associations indicated that in the 1990s



post-Soviet society saw business as being unethical and untrustworthy, in order to address this problem it is necessary to understand the reasons why.

### 6.5.3 Business Ethics and Trust

Although ethics<sup>69</sup> are nothing to do with social attitudes, they do reflect the principals and values upon which society acts and business is conducted. One researcher stated that in Russia the absence of business ethics was impeding the development of 'civilised non-criminal' entrepreneurship (Chepurenko, 1997). This does not mean that Russians lacked ethical guidelines or suffered from a moral vacuum, rather the social, economic and political environments compelled people to use different moral and ethical guides to the ones normally accepted by developed western nations.

The social ethos inherited from the Soviet period that gave tacit approval to individuals stealing from the state, was in the 1990s combined with a social ethos that appeared to condone violence to gain property and capital (Frisby, 1998). All business including SMEs felt compelled to avoid state regulations, engage in tax evasion, but also to approach criminal structures to obtain the kinds of services that legitimate organisations should have but were not providing (see the Availability of the Factors of Production section 5.4.4). One report indicated that 70-80% of Russians considered that laws were not working, and 70% believed that they had to engage in illegal actions just to guarantee their legitimate rights (Domrin, 2003). Moreover, keeping information from the state was not considered as morally unacceptable or unethical. Instead criminality and evasion were understood as necessary survival tactics and the normal way of working for business in a system, where state policies were particularly constraining<sup>70</sup>. This meant the development of business ethics that supported a socially conscious market economy were not at that time developing within the mindset of the population, and this was undermining trust



which is usually a necessary prerequisite for business transactions and economic growth

The combination of state policies that were constraining with weak judicial and enforcement institutions created business opportunities for criminal structures<sup>71</sup> to exploit (Kagarlitsky, 2002), but also distorted the working of the free market that was being created in the 1990s. Moreover, the widespread existence of and reliance on these criminal or mafiya groups (sometimes referred to as racketeers or roofs<sup>72</sup>) was evidence of the ineffectiveness of and distrust in state institutions (Humphrey, 2002). Unfortunately in the long run these criminal organisations prevent the development of honest wealth creating business, because they are more likely to extract wealth (or economic rent), restrict competition and use violence and intimidation rather than encourage increased productivity or innovation. Criminal organisations are not overly predatory, they need the business to make and launder money (Ries, 1998), but the businesses involved with them do not avoid transaction costs completely. They will for instance have to adapt to the criminal organisation's ethics, codes of conduct or ways of conducting business; moreover the criminal organisation's demands on the business, monetary or non-monetary, can depress incentive and discourage innovation. Certainly Braguinsky and Yavlinsky in their work stress that anyone who entertains the idea of starting a small business will almost certainly have to deal with the mafiya and its extortion demands (2000) and this may have depressed the numbers of SME formations in the 1990s.

It was not just criminal organisations that contributed to distrust in business; the actions of state officials at the local level were just as important.



### 6.5.3.1 Bribery and Government Corruption: its Effects on Trust

According to Humphrey the western press tends to generalise about the system of favours in Russia, which gives the impression that the country is corrupt and criminalised. Favours in Russia though have to be understood within their historical and cultural context. This is not to say that some favours are not seen as corrupt they are, but they may be forced on people because of circumstances and consequently will not be judged as corrupt or illegal (Humphrey, 2002). In Soviet Russia there were two main ways of obtaining favours through *blat* or by *vziatka* both of which have been inherited into the social environment of the 1990s and will be discussed below.

*Blat* in Russian society was a way of obtaining a favour that was never considered to involve corruption, it was simply a form of reciprocal help provided within networks of friends, relatives and other personal acquaintances to make it easier to access scarce everyday goods and services. Although it was illicit, it was not regarded socially as a dishonest act (Lonkila, 1997); for example the *tolkach* in Soviet Russia used *blat* (Humphrey, 2002). In other words *blat* was a situational phenomenon, and although it still existed in the 1990s, its nature had begun to change as the economy became monetarised. Consequently the positive aspects of self-help began to disappear in the 1990s, as individualism replaced social solidarity and social inequality grew (Frisby, 1998). For business and especially new SMEs it remained an important survival tool, that was important in an imperfect market, where information was scarce and generalised inter-personal trust levels in society and in state institutions and officials were low. The gradually changing nature of *blat* in the 1990s carried the danger that in the future it could become more like the less acceptable form '*vzyatka*'. For business in the 1990s though *blat* remained largely a positive phenomenon that helped business operate in the changing economic and



political environments, where transaction costs were high, institutions unpredictable and trust low.

The less acceptable way of obtaining favours was *vzyatka*<sup>73</sup>, which is more akin to the western conceptualisation of corruption, where a non-voluntary payment is made, often to an official or bureaucrat for a service that should be free and open equally to everyone (Humphrey, 2002). As in the Soviet period officials took advantage of their power<sup>74</sup>, but also in the 1990s of the uncertainty over regulations to make demands on SMEs, and especially those that had unwittingly overstepped the law. Certainly one survey found that 56% of the population considered the government, other federal bodies and officials to be corrupt (Domrin, 2003, see also Shamseyeva, 2004). Although such bribery was morally despised by Russian society in the 1990s, it was nonetheless resigned to it. The problem is that corruption prevents trust from being established between the public and what are in effect supposed to be public servants, but it also destroys trust in the formal institutions or the system itself (Frisby, 1998). At the local level in Rostov oblast, the businesses interviewed expressed distrust not just of local officials, but also in the local SME funds and support systems (Informants 7 and 5).

There were many attempts by the state during 1990s to curb official corruption but it was largely unsuccessful<sup>75</sup>. Corruption is often explained away or justified by the low salaries of bureaucrats and traditional social attitudes. Unfortunately though in the Soviet period bureaucratic corruption became closely associated with criminal groups, and in the 1990s this impression did not change. The widespread existence of corruption and economic crime which continued unpunished, only persuaded the public that crime and corruption could pay, especially when they result in power and position (Frisby, 1998).



Corruption and the need to use personal connections in the 1990s not only lowered trust in state institutions, it weakened them and prevented them from being effective (Shopflin, 1997). Consequently bills were not paid, contracts were not fulfilled and illegal activities were undertaken, so not only were business relationships damaged, but future unknown business relationships would have been damaged too. Business was increasingly perceived as involving deception rather than as an economic activity that can be mutually beneficial for all those involved. Such a generalised failure of trust could be taken as indicative of a social environment, where inherited social attitudes although changing were still not supportive of success and the trappings of wealth this brought, and hence contributed to the slow formation and development of SMEs.

#### 6.5.4 The Socio-Cultural Environment and Small Business

Small firm formation according to evidence from opinion polls has largely been accepted by post-Soviet society. This should in theory provide an important stimulus for people who have the skills and motivation to find and exploit opportunities. Unfortunately though some social barriers have remained to deter this form of entrepreneurship. One of the most important barriers inherited from the Soviet period was social egalitarianism and income equality. Wealth and business success in the early post-Soviet period though had reinforced social inequality and the stark polarisation of income as a result of the introduction of the market. Hostility to this kind of success was more than simple envy, the ability to become wealthy was not open to everyone equally, it was only open to those with the right connections, or with the audacity to engage in corrupt and dishonest practices. Consequently if corruption became necessary for the survival of small firms, then for some this would



have been as much as a disincentive to engage in this economic activity as it was an incentive for others.

The social environment in the 1990s whilst not disapproving of small firm activity did not provide the right incentives for those with the skills to set up a small firm. The nascent middle class was not yet in a position to invest in risky SME activities. This was because the formal and informal institutions that were created did not encourage investment in SMEs, but they enabled those with powerful connections to control some of the largest and most profitable former state-owned enterprises. The only way to discourage such type of behaviour is to develop the right type of wealth creating institutions to control the economic environment. To be effective though this needs a state bureaucracy that can be seen to be trustworthy and honest, rather than one that engages in or enables others to engage in opportunistic rent seeking activities.

The socio-cultural environment in post-Soviet Russia inherited a deep distrust of the state, distrust of organised crime and successful business. Opportunistic practices by bureaucrats were allowed to continue unchecked. The slow development of civil society and the low level of involvement in NGOs did not help to garner sufficient societal experience of generalised inter-personal trust based relationships. In a society that had wide networks of relationships, distrust should not have been an issue. These networks of relationships though were situational, and the situation in post-Soviet Russia had changed as a result of the marketisation of the economy. This caused changes to many social networks, which were then exploited by those with power, such as officials and criminal groups, who operated using different ethics, but it also increased levels of distrust in society. This though does not mean that there was a complete absence of generalised inter-personal trust based relationships. Small businesses have been developing informal networks of



contacts (see section 6.4.1, The Role of Geography on the Economic Environment), which have helped the development of ethical business practices and have built up trust-based relationships. The problem is that they have remained small-scale, and without sufficient legal protection are likely to remain so.

In conclusion to this section the socio-cultural environment did not provide sufficient incentive to support small firm formation and development. Rather informal institutions contributed to inhibiting new firm formation and growth, because they did not sufficiently support formal institutions, business success, nor the evolution of generalised (interpersonal) trust-based relationships or ethical business practices. Moreover even though informal institutions did not condone corrupt practices, they nonetheless were not strong enough to prevent them.

## **6.6 Small Firms in Rostov Oblast's Food Industry**

As this chapter has shown Rostov oblast had a small firm sector which even grew in the 1990s. Although this small firm sector remained modest in size the oblast nonetheless was in the top ten regions for small firm formation. Moreover, one of the most important sectors for SMEs was food-processing, which was supported by the regions comparative advantage in agriculture. Overall the numbers of small firm formations remained largely constant between 1995 and 2000, except for a peak between 1997-1998 which was not sustained. The higher levels of small firm formations in this period suggested that the upsurge was due to a short-term phenomenon, rather than connected with any real institutional change, which might have supported sustained increases in SME formations. This chapter has confirmed that poor progress in developing the right type of formal institutions has together with Russia's informal institutions contributed to the overall low rate of small firm formations.



The economic environment in Russia remained hostile to SMEs despite the reform of the formal institutional structures. The state attempted to create an 'institutionally thick environment' with a sufficient opportunity structure and the right kind of incentives, but instead the formal and informal institutions supported the wrong kind of incentives. This had as much to do with the increased and unrestrained power of local bureaucrats to extract opportunistic rents as it did with ineffective formal institutions. Dealing with the local administration to gain necessary licences and certificates, pay taxes and so on, as well as obtain all the factors of production involved high transaction costs for SMEs. The only way to reduce transaction costs was to rely on personalised contacts or to operate either wholly or partly in the informal economy. Thus it appears that the state through its formal institutions was forcing small business into the informal economy, a situation that would have not suited all potential small firm entrepreneurs.

Opportunities for business did exist and were especially evident in the food-processing sector; for example the small firms that were interviewed for this study undertook important gap filling roles. In other words they were supplying markets that large firms were not with both low priced basic and luxury high priced food products that satisfied demand. These opportunities in food processing were increasingly exploited at the end of 1998 and 1999 following the devaluation of the rouble, but this window of opportunity appears to have closed after 2000. This suggests that the crisis had temporarily hidden some of the worst effects of the new institutional arrangements and even brought some benefits for smaller firms, but that they could not be sustained once the initial effects of devaluation had worn off.

A key reason why the formal institutional environment was not conducive to investment in small firms was because many of the inherited informal institutions (apart from the acceptance in principle of independent economic activity) from the



Soviet period were slow to change. Although attitudes to small firms and concomitantly capitalism became generally more positive over the 1990s, this was not so true of attitudes to success. This was because success in post-Soviet Russian experience became equated with power, corruption and fraudulent practices. Capitalism has consequently become associated with illegality, but also bureaucratic opportunism, which could ultimately undermine economic reforms needed to create a well functioning market economy. A lot of this was connected with the low levels of trust and poor business ethics inherited from the Soviet period. Trust in state institutions, officials and a generalised inter-personal trust based on fair business ethics will only develop if the state takes responsibility for its role in ensuring that institutions work effectively and are not too constraining. Instead the state needs to aid the development of a judicial system that is able to effectively police state abuses and bureaucratic corruption, as well as prevent opportunism and the exploitation of legal loopholes.

Russia in the 1990s did create new institutions, intended to deliver a market economy but they fell short of their intended outcomes. They did not encourage a sustainable supply of entrepreneurs and many members of the middle class in Russia remained cautious and conservative. This was because the new formal institutions and legacy of informal institutions combined to create incentives that were wealth extracting rather than wealth creating. Russia could perhaps be likened to what in the institutional economics literature is termed a 'pirate economy' rather than a productive entrepreneurial driven economy, and certainly not one with a broad base of active entrepreneurs. Although the state adopted capitalist ideology and reformed many of its institutions, to provide the necessary conditions for encouraging entrepreneurship and new firm formation, they were insufficient to guarantee that this would happen. While transaction costs in the economy have remained high, informal institutions from the Soviet and Tsarist past have continued to be influential, so that



the supply of entrepreneurship has been limited by social and cultural factors. The result was that the role of SMEs in a transitional economy was limited and unable to provide the kind of innovative and dynamic influence that they have done in the West.

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## End Notes

<sup>1</sup> The pamphlet on the regional program for state support of small entrepreneurship in Rostov oblast for 1998-99 stated that Rostov oblast was the 6<sup>th</sup> most important region for SMEs and the 4<sup>th</sup> most important region for manufacturing SMEs in Russia (Passport, 1998).

<sup>2</sup> Statistical evidence on the evolution of small firms in Russia is reported by many researchers as being not only scant, but also unreliable (Aslund, 1997b; Barkhatova, 2000).

<sup>3</sup> In Russia just one third of agricultural produce was sold processed, which was a much lower share than in other advanced economies (Ioffe, 2001).

<sup>4</sup> Aslund emphasised that the government's role was potentially more harmful to small firms than both crime and a difficult economic environment. He showed that during the economically turbulent years of 1991-3 the rate of small firm formations increased because inflation prevented the government from implementing restrictive institutions. By the mid 1990s when the economy had stabilised somewhat and the government had time to develop its small business policy, the rate of SME formations fell (Aslund, 1997). The OECD confirmed that SMEs in Russia were more vulnerable to inconsistent policy, laws and governmental decisions than they were to economic turmoil (OECD, 1996).

<sup>5</sup> The state owned around 12% of the shares in some of the largest food-processing enterprises, and these enterprises produced about 40% of all food products (OECD, 1998).

<sup>6</sup> For more information see also the internet site for the FAO at [www.fao.org/waice](http://www.fao.org/waice).

<sup>7</sup> The Soviet period had created large food-processing enterprises sometimes there was just one milk enterprise or one meat combine serving several localities (or raions) within a region (Serova, 1999a).

<sup>8</sup> The decline in demand for agricultural raw material meant farm gate prices were kept low, moreover processors also tried to pass on their costs to farmers, at the same time input prices for agricultural farms grew to world market levels (OECD, 1998).

<sup>9</sup> Re-organisation of former state and collective farms was more of a re-registration under new legal forms, few broke up into separate enterprises and few farm members exited to form their own *fermerskie* farms. (Goskomstat, 1996). In Rostov oblast nearly 91% of farm employees leased their land shares back to the parent farm (Wegren, 2000). According to Serova the numbers of private farms was increasing in 1992, but fell from 1994 when they lost their government subsidies. Moreover they were unable to compete in the market with large farms for access to the agricultural market infrastructure, which continued to prefer operating with large units. (Serova, 1999b; Wegren, 2000). The overall lack of interest in *fermerskie* farms was also partly blamed on incomplete legislation, but even when legislation was improved many agricultural workers did not receive the plots of land they were allotted. According to Serova this was principally due to the limited nature of land resources available or due to the type of farming conducted on the land (Serova, 1999a).

<sup>10</sup> Just 5% of farm members decided to sell their land shares (Wegren, 2000). Small *fermerskie* farmers consequently encountered difficulties in buying up land, and even leasing land was not feasible for them because of limited availability of finance.

<sup>11</sup> Serova writes that most family farms were subsistence farms and did not sell on agricultural markets (Serova, 1999b).

<sup>12</sup> Undated internet essay, 'Evolution of the Farm Structure in Russia's Agriculture: Background and Perspectives', (Serova, E.).

<sup>13</sup> The basket of 19 basic food products included :- beef (category 1), sausage (type 1), sausage (type 2), butter, vegetable oil, milk, sour cream, cheese (standard types), eggs, sugar, bread (rye), bread (white), millet groats, vermicelli (spaghetti), potatoes, cabbage, onions, apples, cigarettes (Gardner, Brooks, 1993). According to the Rostov statistical office these 19 products were also on the list of suppressed prices in Rostov oblast (Gardner and Brooks, 1993).

<sup>14</sup> See FAO internet site at [www.fao.waice](http://www.fao.waice).

<sup>15</sup> Imports of raw materials decreased for example grain imports into Russia fell from 30 mn tonnes in 1992 to 4 mn tonnes a year between 1994-6. Imports of processed food increased, for example imports of meat and meat products increased from 0.5 mn tonnes in 1992 to about 2mn tonnes in 1995 (Kwiecinski, 1998). Imports from the West were often cheaper or not much more expensive than similar domestic products, and their smart packaging and marketing was difficult to compete against. A proportion of processed food imports also came from East European countries (including the Baltic states, Hungary, Bulgaria and Poland) (Smallbone et al, 1999a,b,c,d). These products tended to consist of processed potato products, fruit and vegetable based products, but the share of these imports was lower due to their low output levels, smaller product assortment and high transport costs (Mitchell, 1996).

<sup>16</sup> Imported food products into Moscow took over markets that had traditionally been important for the large former state-owned meat processing firms in Rostov oblast (Informant 6).

<sup>17</sup> According to Goncharov technical equipment within the food industry had aged by 40-60% and was in need of urgent replacement. The level of technical obsolescence was not uniform across all food processing sub-sectors, certain industries suffered more from very low modernisation levels (Goncharov, 1998). The need for modernisation



was evident in Rostov oblast because in 1995 just a small amount of processed food was sold in packages, this included 37% of cream, 12% of animal fat out of the total amount produced (Zolotarev, et al 1995).

<sup>18</sup> Regional subsidies and bans on exporting to other regions prevented a single national food market from developing, as regions tried to ensure that only their region's citizens benefited from the region's budgetary resources. (Serova, 1999a).

<sup>19</sup> Unions of major product groups exist in the food industry – for example the union of meat manufacturers, sugar union, grain union, beer union, conserve union. Each oblast and krai has at least one food union. The director of the conserve union had worked in the industry for 20 years. He knew directors in the conserve unions in different regions as well. The various regional unions helped each other out through bartering raw materials. He called up other conserve unions in other oblasts to tell them what he needed; they would send it to him and vice versa (Informant 8). Director of the meat union sent two trading firms in his union to Moscow to obtain orders, which he then distributed to member enterprises (Informant 6).

<sup>20</sup> January to May 1992 a tight monetary policy was pursued, from May to June 1992 this policy was softened because production levels were falling (Frenkel', 1998; Aslund, 1994). In the fourth quarter of 1992 the state returned to a tight credit policy towards former state-owned enterprises (Frenkel', 1998) by reducing the number of credits and taking active measures to control inflation. The tight monetary policy continued into the first quarter of 1993. In the second and third quarters of 1993 despite tight monetary controls budgetary expenditure increased and money went into industry, one recipient of subsidies was agriculture and the food industry (Fischer, 1994; Frenkel', 1998). The fourth quarter of 1993 monetary policy tightened again which helped to reduce inflation (Frenkel', 1998). At the beginning of 1994 a tight monetary policy was in force, however by the spring the numbers of subsidies to a variety of industrial branches including the agro industrial complex had increased (Frenkel', 1998). This softening of the monetary policy contributed to the collapse of the rouble in October 1994 (known as Black Tuesday) and contributed to high levels of inflation (Frenkel', 1998). Since the last quarter of 1994 the state has pursued a relatively tight monetary policy (Frenkel', 1998). According to the EBRD it was only in late 1994 that a true course of stabilisation was followed and from this time onwards it led to a sharp and consistent fall in inflation (EBRD, 1998). By August 1998 the rouble could no longer be defended and the Russian government declared itself bankrupt (Gustafson, 1999).

<sup>21</sup> There was an import subsidy on some imported agricultural items in 1992 – for example butter, cheese, milk powder, meat and meat products, vegetable oils, fruits and vegetables, sugar and flour (Serova, 1992, 1999a), these subsidies were later abolished in 1993 when they were replaced with tariffs and customs duties. The former state-owned food processing enterprises benefited from import subsidies because they were able to obtain agricultural inputs at a fraction of the actual worth of the product and were cheaper than domestically produced inputs (Serova, 1992, 1999a). Even without import subsidies the amount of imported food increased, in 1996 it was estimated that imports of poultry and even of vegetables and fruit products came to 97% of the total volume of production of those same products in Russia (Kovapenko, 1998). In Rostov oblast the effects of imports on the fall in its local agricultural output were not as severe as elsewhere in Russia because import penetration was lower.

<sup>22</sup> Devaluation meant that the value of the rouble declined whilst the price of imports rose and this caused a fall in the volume of imports between August and October 1998 into Russia (Vekova, 1998).

<sup>23</sup> Although the arbitration courts were not popular, they were increasingly being used in the major cities of St Petersburg and Moscow by the end of the 1990s. This was because they were seen as becoming more effective in defending private property against abuses by the state (Gustafson, 1999) especially when there were contracts, which are increasingly seen as a key business tool. Although contracts were becoming more important they were still underdeveloped and their use remained restricted. Moreover although a contract could be used as an important bargaining tool when commercial relations were established, they were not always implemented (Gustafson, 1999).

<sup>24</sup> According to a report published in 2001 The Ministry for Anti-Monopoly Policy and Support of Entrepreneurship of the Russian Federation (Map) is the key national institution in charge of small business policy. The Ministry for Trade and Economic Development was also a key state organisation involved in SME policy making from 2000. The State Committee for Small Business Support was abolished (Russian SME Resource Centre, 2001).

<sup>25</sup> Humphrey comments that visible profit is heavily taxed (Humphrey, 2000). According to Avilova a taxation decree in 1993 raised the rate of profit tax and allowed the local authorities to impose additional taxes. (Avilova et al, 1996).

<sup>26</sup> One popular method of avoiding tax was to use cash and leave no paper trail. According to Gustafson almost all businesses had two sets of records. One set was used for reporting to the authorities and the second 'unofficial' set was used to record cash only transactions. Reported official transactions tended to have low profit margin levels, but every deal had a 'hidden unofficial' cash component, often in dollars and this was the actual profit paid. (Gustafson, 1999). In addition the business would declare expenses that it never had, for example a business would forge contracts and receipts (Chokh, 1997). Another way of avoiding taxation was to pay a local mafiya organisation a percentage of the revenue, which protected the business from the tax inspectorate. Another method was to obtain privileged tax exemptions for small business in a priority sector (Easter et al, 1998). For example some favoured sectors were exempt from tax for 2 years from the date of registration and in the 3<sup>rd</sup> and 4<sup>th</sup> year tax was levied at 25% and 50% of the normal tax rate. Other tax exemptions were granted if profits were used for construction or technological renovation. Food-processing was only able to obtain such exemptions from 1995 onwards (OECD, 1998a). Easter et al (1998) reports that experts consider that up to just 30% of small businesses had access to these privileges. Some businesses to obtain as many tax concessions as possible opened then closed a string of different businesses in different priority sectors. This artificially inflated the numbers of new business formations. Yet another way of avoiding taxation is to produce exclusively in the informal economy which meant that such firms remained invisible to the authorities and had no legal status or protection.

<sup>27</sup> The budget received 73% of its planned income in 1992 (Frenkel, 1998). Tax revenues fell from just over 44% of GDP to less than 30% between 1992-1996 (EBRD, 1997).

<sup>28</sup> There was no set procedure for obtaining a licence nor any clear classification of what type of activity required a licence (the classifications that did exist contained discrepancies between the federal list and regional lists (Easter et al, 1998).

<sup>29</sup> Small business support in Rostov region had the following objectives.

- To create a standard legal basis to enable the regional government to support small firm entrepreneurship.
- To create financial, credit and investment support for small entrepreneurship.



- To create production and innovation support for small business
  - To create and develop the infrastructure to support small business
  - To improve availability of information to small business.
  - To improve access to technology and technical support and ensure a trained labour force for small business.
- (source Shipilova, 1997)

This was very similar to the federal policy.

<sup>30</sup> The 1996 programme which concentrated on providing infrastructure support to SMEs in Rostov such as consulting, information and incubation centres was according to one interview in December 1998 still not completed, for example the incubator in Rostov on Don was still unavailable for use in 1998 two years after being announced (Informant 13).

<sup>31</sup> Setting up the financial and information infrastructure for example mutual credit societies (obtaining agreements with banks to provide low cost loans to SMEs) was successful and the low cost leasing programme failed because the leasing firm did not operate (Shipilova, 1997).

<sup>32</sup> Planners had located food-processing plants either near urban areas of consumption or on agricultural enterprises depending on ease of transportation, rate of spoilage, and the use of preservatives. In Rostov oblast an easily spoiled product such as milk and dairy products meant that dairies were located in each of the 43 raions (localities). A more robust food product such as meat was processed in just 18 raions (localities) (REF, VNIIEiN, 1994). In 1994 in the oblast there were 38 town bakeries, 174 confectionery factories, 166 plants and district producer plants in almost all raions, and there are 2 specialised enterprises of fat/butter refineries and 11 breweries. (VNIIEiN, 1994). As a result within the Rostov food industry there was already a certain level of competition and a relative absence of conservative monopsonistic producers typical of some other sectors or regions.

<sup>33</sup> The Russian Academy of Agricultural Science the All Russian Scientific-research Institute of Economics and Standards VNIIEiN).

<sup>34</sup> For example flourmills, bakeries, fat/butter refineries, creameries and dairies.

<sup>35</sup> One example is from Kuibyshevskii raion in Rostov oblast where the Leninskoe co-operative was formed out of 8 fermerski farmers (who in this instance happen to be relatives), another is in Konstantinovskii raion where Kfkh Luch was formed by 4 fermerski farmers to process their own grain in their own mill (Lysenko, 1997). Many of these co-operatives did not just process a single product some for example Fakel 7 processed vegetable oil and produced macaroni (Tarasov, 1997) another co-operative processed agricultural material in its own mill, bakery and oil refinery.

<sup>36</sup> At the beginning of the transition period, it seemed unlikely that new small food-processing firms would have survived. If it was not the harsh economic climate then it was consumer preference for western food products (Humphrey, 2001). Imports though were often of poor quality, and without Russian written instructions not correctly used, so by the mid 1990s there was a swing back to domestically processed Russian food, which was considered to be more healthy and natural because it did not use as many chemicals or preservatives. This created opportunities for small food processing firms.

<sup>37</sup> FIGs unite financial and industrial capital and can remove obstacles to investment (EBRD, 1998).

<sup>38</sup> The cost price squeeze (increased inputs and decreased output prices), plus lack of liquidity and rising indebtedness reduced the working and investment capital available and the ability of agricultural enterprises to purchase inputs. Agriculture was considered a high risk sector, because of its Soviet record of needing subsidies to survive (OECD, 1998a).

<sup>39</sup> The managers of the confectionery factory approached Priroda because of the way that they had rebuilt a fish combine that had been saddled with debts, had ancient equipment and a lack of orders. With the support of Donkombank Priroda invested about 3 million roubles in the confectionary plant. In return for their help in restarting production at the factory after 3 years of not working, Priroda and the FIG Donkombank were given a controlling packet of shares. (Gorod, N no 44, 4-10 Nov, 1998).

<sup>40</sup> It is necessary to distinguish between barter in the virtual economy and the informal economy. The virtual economy is a paperless economy using inter-enterprise debt or credit. In the informal money is exchanged and industry operates as it would in the formal economy but its output is illegal or illicit.

<sup>41</sup> Studies on transitional economies state that the informal economy is large in all of these countries, however the growth of the informal economy in Russia has been happening at an alarming speed (Guariglia and Byung, 2001).

<sup>42</sup> The Russian State Committee on Statistics, Goskomstat estimated that the informal economy had grown from 13% in 1993 to 23% in 1996 (Guariglia and Byung, 2001).

<sup>43</sup> Despite the appearance that individual holders of land had full property rights, which included full rights of control (who to hire, what to produce, sales price and so on) and rights to residual income (the right to dispose of income generated by the property having deducted all costs), they did not. This was also evident in the restrictions that were placed on individual holders of land. There are three notable restrictions. Land that was designated as agricultural was not allowed to have its usage changed. Moreover, if the land was considered to be ineffectively used then the authorities had the right to confiscate it (Wegren, 1998). Lastly the land had to be farmed by persons with agricultural knowledge, urban dwellers could not get land from state and collective farms, they were only able to do so from a special land fund that existed in each raion (Wegren, 1998). So eligibility for free land was conditional on having agricultural experience or education. Urban dwellers could only obtain land in rural areas if the land was not used by the large agricultural enterprises (Wegren, 1998).

<sup>44</sup> Although urban land is a less contentious issue in Russia at the beginning of the reform period there were problems associated with the leasing of property by the new small private firms. Regional authorities often contested the right to lease premises of former state-owned firms to SMEs.

<sup>45</sup> The newly drafted 1995 land code, which still had not been passed at the time of the research visit, was supposed to make it easier to sell land plots for all manner of uses. The Decree of March 7<sup>th</sup> 1996 removed restrictions on the amount of land that could be leased (Brooks, et al 1996).

<sup>46</sup> Parliament allowed the legal ownership of urban land in September 2001, (Aris, 2001).

<sup>47</sup> Legislation was passed allowing the creation of a free market in farmland in June 2002. Power over land sales still remained with local authorities, which was not supposed to let more than 10% of farmland go to a single owner. Moreover the local authorities were allowed to define what was farmland and whether it should continue to be used for farming or other purposes, (The Irish Times, 27<sup>th</sup> June 2002; The Moscow Times, 17<sup>th</sup> May 2002; The Economist, 7<sup>th</sup> July 2001).



<sup>48</sup> According to the 1993 presidential decree no 1767 and the civil code, landowners had the right to mortgage their land. Land held in other forms of tenure could not be mortgaged by the holder. Banks though did not accept land as collateral. As a result most loans were secured against assets such as machinery, and livestock (Brooks et al, 1996).

<sup>49</sup> So in Moscow it was common for property to be insured against all kinds of risk except government confiscation (The Moscow Times 1999)

<sup>50</sup> According to this report half of small enterprises selected workers through recommendations of acquaintances, another half via advertising and one fourth by using employment services. Some also used educational institutions. For top and mid level managers 70% of all small firms used recommendations by acquaintances (Russian SME Resource Centre, June 2001). These figures though are problematic. Other surveys by RIISNP during 1996-7 showed the importance of informal methods of personnel recruitment, for example 37% of SMEs found employees from relatives and friends, 38% from former colleagues (Easter et al, 1998).

<sup>51</sup> This may gradually have become less of a problem for SMEs as the ability of the former state-owned firms to provide these services fell during transition, suggesting the overhead costs of retaining labour were onerous.

<sup>52</sup> Private fermerksi farms have tended to be extremely small and widely dispersed. In Rostov oblast for example small farms on average were about 11 hectares in size (Wegren, 2000). Even if they were able to produce sufficient quantities they lacked the necessary political connections to market their output (Spoor, 2001). In addition many small farms have closed due to insufficient infrastructure support such as running water, electricity, road systems, lack of credit, rent seeking tax authorities, high fuel and fertilizer prices and inefficient and fragmented markets (Spoor, 2001).

<sup>53</sup> The large former state owned enterprises never controlled their own payments. Payment for inputs was an administrative process carried out by the banks. It was not dependent on the enterprise having sufficient funds, and the enterprises themselves did not have to concern themselves with payments or their capability to pay

<sup>54</sup> **Organisations Supporting Small Business Development.**

There have been a variety of organisations that have established to support the development of small business. These organisations existed throughout Russia as well as Rostov oblast. Akkor the association of peasant farms and co-operatives was founded in 1989-90 by the state. Although it was principally formed to support state reform of agriculture, Tacis considered that in Rostov it was dynamic. Akkor was not located in all 43 raions of the oblast but just 26. This was because farmers questioned the effectiveness of this organisation and were consequently reluctant to become members. Akkor was to help small farmers develop book keeping systems, marketing, provide information on access to suppliers and sales (Dmitrenko et al, 1994) but farmers complained that Akkor did not provide all these services. No matter how insignificant the help, evidence showed that Akkor helped a co-operative in Verknedonskii raion to establish a processing plant by providing 51% of the capital needed (<http://europa.eu.int/comm/europeaid/projects/tdp/en/document/alldoc/agrifood/rostov>).

### **International Donor Programmes**

Many of the international donor programmes operated in Rostov oblast, but not all were helping to develop small business. For example at the time of the research trips to Rostov oblast, the EBRD did not have any specific SME projects. The Tacis project that was running was providing technical help to small fermerski farms. It was USAID that was supporting small business irrespective of its sector. The positive side of the programmes designed by international organisations in general was that they promoted the development of small firms and underlined their importance in an economy. They highlighted the shortcomings that existed in Russian institutions such as registration problems, financial problems and fiscal problems and that other services such as technical support had the potential to be very valuable. During the period of the research field work in the Autumn of 1998 the USAID organisation operating in Rostov oblast had provided financial support to a variety of small businesses, and was working closely with a small wholesale organisation to support its financial needs. The small bakers that were interviewed in the autumn though had not approached USAID. During March 1998 whilst visiting the Tacis project that dealt with offering support to private farmers a consultant from 'Opportunity' USAID was having a discussion with a small farmer trying to gain financial support for his bakery. This researcher sat in on the less important aspects of the discussion. During the course of the conversation the farmer was told by the 'Opportunity' consultant that if he was granted money for his bakery business he would have to relinquish his logging business. This was because the farmer should not have his attention distracted from his main business, he would not be able to do both if he wanted to be profitable. On surface this seems justifiable and reasonable advice, however, in other countries such as Peru it is common to see small business owners diversify into several activities. Long (1979) shows in his analysis of small firms in Peru that in unstable economies, diversification is a form of insurance, protecting profits in case of failure so that a reasonable income level is assured for the family.

<sup>55</sup> For example fermerskie farmers were new to finding sources of inputs, and initially they were unaware of just what was available, how to get it and the costs involved, see website:- <http://europa.eu.int/comm/europeaid/projects/tdp/en/document/alldoc/agrifood/rostov>.

<sup>56</sup> In Moscow the average income per person was 3796.3 thousand roubles, in Rostov by comparison it was 766.9 thousand roubles.

<sup>57</sup> To cope with this situation people grew more of their own food on plots of land or dacha plots (Gustafson, 1999).

<sup>58</sup> In August compared to July the average income purchased a further 5-10% less of basic food and non-food products.

<sup>59</sup> This was because devaluation increased prices, though in Rostov this was a 40% increase compared to the Russian average of one and a half times, and for food products the price increase was about 30% (Molot, 27 October, 1998).

<sup>60</sup> Frenkel' (1998) commented that prices grew by the same pace or at even higher speeds both in those regions that were controlling them as well as in those that were not.

<sup>61</sup> Rich areas of the Russian federation included Moscow, Magadan, Murmansk, Sakhalin, Tyumen, Sakha and Komi. At the end of 1992 the average per capita income in the richest areas was 4.9 times higher than in poorest ones (namely Chechnya, Ingushetia, Dagestan, North Osetia (which are all in the North Caucasus) and Moscow oblast and Penza oblast (Buckley, 1994).

<sup>62</sup> Moscow town has an average income per head of 3796.3 thousand roubles, whereas for Rostov inhabitants it is only 766.9 thousand roubles (Gorod N, 21-27 January 1998).



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<sup>63</sup> Grigory Yavlinsky (2004), Demodernization [www.eng.yabloko.ru/People/YAV/01-1102.html](http://www.eng.yabloko.ru/People/YAV/01-1102.html). At least 30% of the population live in absolute poverty.

<sup>64</sup> The oligarchs are a small group of financial magnates with close government relations (Schroeder, 2000). Research carried out by the Russian Academy of Sciences has shown that over 60% of the wealthiest millionaires and 75% of the new political elites were former members of the communist nomenklatura, and 38% of Russian business people held economic positions in the communist party (US Library of Congress, internet undated article, [www.countrystudies.us/rusia/27.html](http://www.countrystudies.us/rusia/27.html)).

<sup>65</sup> Instead of a middle class, the Moscow Times considers that a class of rent seekers has developed (The Moscow Times, 25<sup>th</sup> December 2003). Also Braguinsky and Yavlinsky (2000) write that there is no middle class but there are 'robber barons', who stifle economic growth by stealing from Russia and investing abroad.

<sup>66</sup> Just 10-15% of the population were middle class and owed their relative prosperity to the transitional system. These were its chief defenders. Many able people who had the skills to create a wealth producing country were not given the chance and those with wealth were more interested in consumption. According to Burdeau's article the middle class formed just 8% of the population with income levels ranging from \$300 to \$2,000 per month per family (Burdeau, 2001).

<sup>67</sup> Many would-be middle class members of society were known as the working poor in Russia – doctors, teachers and other skilled workers had wages that were so low they can hardly make ends meet, and finding another job was impossible (Klimova, 2004).

<sup>68</sup> Other surveys also indicated there was no objection to people owning SMEs or small plots of agricultural land (Christensen, 2000).

37 Leninism-Marxism provided a source of collective moral authority and collective responsibility; in the 1990s there was a moral vacuum and individual irresponsibility.

[www.heritage.org/ies/forpol/cbrief13.html](http://www.heritage.org/ies/forpol/cbrief13.html) – committee brief no 13 21/06/ 1995, von der Heydt.

<sup>70</sup> High levels of corruption exist in economies of transition, EBRD, 1997. Overall tolerance to petty economic crime was a legacy from Soviet regime. This happened because people in the USSR became socialised in widespread deviance just to survive, in a system where shortages, bribery and thieving were prevalent, no single area of life in the Soviet Union was exempt from corruption (Frisby, 1998).

<sup>71</sup> The historical origins of criminal organisations like the mafiya may stretch back to the 17<sup>th</sup> century (see Humphrey, 2002) or they could have been a more recent development that started in the 1920s or 1970s. Whatever the truth, criminal organisations became very prominent in the late Soviet period of the 1970s and 1980s (Frisby, 1998; Humphrey, 2002). Moreover these groups had not been controlled by the police and enforcement agencies this was largely because in Soviet Russia the enemy was political rather than criminal. These racketeers and criminals who originally were imprisoned in camps were the originators of the Russian mafiyas that became even more powerful in the 1990s.

<sup>72</sup> Roofs in Russia are krysha, they are patrons in legitimate power such as ministry officials, bureaucrats as well as ordinary racketeers.

<sup>73</sup> For the small businessman dealing with local government was a constant headache. From registering, to licensing the business had to sweeten the bureaucratic red tape with bribes and cultivate useful friends in government. (Gustafson, 1999).

<sup>74</sup> One small wholesaler in Rostov oblast was obliged to open a restaurant /night club for bureaucrats to use free of charge in order to obtain permission to operate and have less stringent checks by the various local state departments (Informant 5). The impression from this interview was that he did not trust bureaucrats he just did what they wanted for a peaceful business life.

<sup>75</sup> In 1999 crime and corruption by Russian government officials increased by over 35% according to a representative from the Interior Ministry and charges were brought against 21,000 officials (Johnsons Russia List; 2<sup>nd</sup> March 2000).



## Chapter 7

# Understanding Independent Small Firm Formation in Russia During the 1990s

### Chapter Outline

Traditional explanations for small firm formation and growth though useful do not provide a comprehensive understanding of this phenomenon, especially for countries that have not followed western models of development. This study addressed this shortcoming by creating a conceptual framework based on the literature of institutional economics that combined approaches from political-economy and sociology. The results confirmed that SME activity was dependent on much more than just conditions in the economic environment, it was shaped by the interaction of formal and informal institutions and the incentives and disincentives they created. It became apparent that although the formal institutions adopted by Russia in the 1990s were similar to those found in successful western nations, its informal institutions prevented them from operating in an equivalent manner. Moreover these formal institutions in Russia could even be termed 'bad' because they encouraged wealth extraction and rent seeking rather than economically productive activities. More importantly the constraints they imposed on SMEs seemed to be pushing small firms into the informal economy. Before discussing these and other findings this final chapter examines the contribution that this study has made to understanding the complex nature of small firm activity in an economic system undergoing transition. The chapter then details how the conceptual framework, on which the study was based, was created. After discussing the findings, the chapter assesses the methodology employed and finally looks at how the conceptual framework can be used in future studies.

## 7.1 Introduction

This study began by questioning which circumstances and factors were determining small firm formation in Russia during the early stages of transition. A preliminary reading of the general literature on transition and especially on small business within transitional economies showed that it appeared to deal in a perfunctory manner with some of the issues. In particular there was an under-appreciation of the continued influence of the Soviet past. Moreover, existing studies on economic development and small firm research tended to emphasise certain factors such as geography, availability of raw materials, finance and the motives of entrepreneurs. Important as they are, questions had been raised by some researchers about whether such explanations were sufficient for understanding the complexity of economic development (see Olson et al, 2000). They argued there were more fundamental reasons behind economic growth, and as economic development and small firm activity are connected it seemed pertinent to examine them in this study.



The literature on Third World development, asks the simple question, why, despite continued western support have these countries have remained poor? The implication for this study was that reliance on policy design using western models, that had not been sufficiently adapted, was unlikely to stimulate economic growth or encourage small firm activity in Russia. The reason, according to those that have studied the Third World, was because of the incompatibility of adopted western (formal) and inherited domestic (formal and informal) institutions (Olson, 2000). Institutions are the fundamental building blocks of any economy that determine the path of economic development, but if there is discordance, for whatever reason, between formal institutions or formal and informal institutions then the path to economic growth may even take a wrong turn. Given the key role of small firms in economic development it would appear that an institutional perspective could provide valuable analytical insights into this form of economic activity.

This section provides a brief reminder of the original research questions and some of this study's answers that will be expanded on later in this chapter. The central research question was by design very broad aiming to uncover the factors and circumstances shaping small business formation within a specific manufacturing sector over time in a particular region of Russia. To obtain answers to this, sub-research questions were formed to examine the influence of the political, economic and socio-cultural environments on SME activity.

The first sub-question examined the nature of the opportunities that were available within the economic environment for new small-scale manufacturing. In brief, this study showed that market opportunities had existed throughout history, but that formal institutions and high transaction costs created too many disincentives for them to be fully exploited by small firms. Understanding whether opportunities were taken up and how they were exploited by SMEs required an understanding of socio-



cultural influences on economic activity. Consequently the second question looked at the role that society and culture played in informing who set up small firms as well as the reasons why and why not. This study examined different social groups and the opportunities they had for entrepreneurship historically. Russian history showed that some groups, especially those with power had more opportunities, but their reactions (in response to the prevailing institutions) were to act conservatively and avoid risk, or to extract wealth rather than invest. The study also evaluated such informal institutions as business ethics and trust and the role they played. Historically low trust levels and poor business ethics have prevailed and have contributed to dampening incentives for SME activity.

From the beginning the influence of history and past legacies were considered important for this study, so one question examined whether history could contribute to understanding small firm activity in Russia during the 1990s? As some studies have shown (North, 1991a, b, 1997, 1994) institutions (formal and informal) even following revolution continue to evolve in a path dependent manner. In this study it became clear that the old Soviet formal and informal institutions continued to exert an influence on all economic activity including SMEs. For example in the 1990s land remained state-owned, so at the time of the research visit (1998) most small business owners leased land and premises. This aspect of property rights proved to be a disincentive to long-term investment for some SME owners (Informant 7), and was one reason why many activities were constricted and SMEs were prevented from making an even greater contribution to economic development. The fourth question was principally concerned with the role of the federal and regional state in shaping formal institutions. This study showed that although state rhetoric was supportive of small firm formation, the formal institutions introduced were inadequate and ineffective. The state, at both levels, seemed more concerned with supporting



large former state-owned firms through the transition process than they were in encouraging small firm activity.

Before examining in more detail the findings of this study, it is important first to appreciate the contribution this study has made to understanding small firm formation in a region during the transition period.

## **7.2 The Contribution of this Study**

This study claims several contributions to small firm research in transitional economies. It created and applied a conceptual framework, which is believed to be an original synthesis of concepts from different, hitherto separate traditions of explanation. This framework successfully guided data collection and the organisation of the analytical narrative in the historical chapters four and five and the analysis of the transition period in chapter 6. It highlighted the function of key factors such as the role formal institutions played in creating the incentives and parameters for SME activity, and the influence of informal institutions on whether and how these incentives were taken up. In addition the analysis was set within historical and place specific contexts.

To understand the underlying causes of small firm formation the conceptual framework combined a traditional economic analysis with an examination of socio-cultural and political influences. Traditional economic explanations, according to an institutional perspective, can be likened to understanding the symptoms that have been aggravated by the economic environment (in other words the dependent variables). They do not cause economic activity; this accolade belongs to institutions (formal and informal) they are the independent variables on which all economic activity depends. Therefore one important contribution of this study was to use



institutions to analyse the nature of the complexity of small firm activity in a transitional economy. As in all economies whether they are undergoing a transition as fundamental as Russia's or not, the state creates the formal institutions. The state in devising these institutions is guided by an ideology that represents a belief system and this defines the state's overall aims, which are then used to shape policy, legislation and regulations. Throughout Russia's history state ideology has shaped formal institutions, and these beliefs and aims account for the differences but also similarities in the institutions from the Soviet and Tsarist periods, as well as the post-Soviet period. Changing formal institutions need not be difficult for the state once its ideology has changed and the ruling elite is committed to change. This may account for the assumption at the start of transition by some analysts, that formal institutional restructuring would be sufficient on its own to produce the desired changes in economic activity and behaviour (see Smith and Pickles, 1998). The Russian experience though has shown the difficulty of introducing the 'right' type of formal institution to generate the 'right' kind of behavioural response in society. This was because the existing formal institutions have generated certain routines and habits. If these formal institutions change for whatever reason, routines and habits will not necessarily alter as well, and even if they do this need not be as predicted or hoped (Stark and Bruszt, 1999). In transition economies the state made the conscious decision to implement a tried and tested 'blue print' of western market institutions (privatisation, liberalisation, marketisation), but there was little consideration of how these institutions would be affected by pre-existing habits and routines (in other words informal institutions).

Informal institutions then may obstruct the desired change to economic activity that the new formal institutions were designed to achieve. For instance the formal institutions of the old Soviet state outlawed independent economic activity, but informal institutions endorsed a certain type of opportunism that enabled it to exist



(see chapter 5 section 5.5.3 on Trust in Business and Society). These informal institutions that supported opportunistic practices were inherited into post-Soviet Russia but they undermined the development of ethical business practices and the importance of the rule of law. So although political reform allowed small firms to legally form in the formal economy, the informal institutions encouraged many to operate either wholly or partly in the informal economy in illegal as well as illicit activities.

In recognising the role of informal institutions attention is also drawn to social attitudes towards business, business ethics and *trust* and how they determine the effectiveness of formal institutions to create the right kind of incentives and opportunity structure for SME activity. Trust became an increasingly important variable in this study because of the effects it had on SME activity in Russia. Although distrust may not stop SMEs from forming, it will prevent them from growing, because without trust there is nothing to underpin the sort of reliable arms length contractual business relations with unknown partners that is so essential to a functioning market economy (Fukuyama, 1995). In Russia during the 1990s the judicial and enforcement institutions were weak and unable to support contractual business transactions, but had trust been higher it could have taken over that role and may have been sufficient to encourage an increase in SME activity. Distrust in Russia was nothing new, historically there has been distrust of formal institutions and state officials but also there was always a lack of generalised inter-personal trust (between individuals of the general public). Low levels of all kinds of trust in Russia in the 1990s kept investment in SMEs low, discouraged their growth, encouraged only short-term business objectives and personalised business transactions.

To fully understand the influence of formal and informal institutions the analytical tool of transaction costs was applied to explain the nature of SME activity.



*Transaction cost* analysis was particularly important because as Douglass North (1991) writes there is no such thing as a 'costless transaction'. A transaction involves an exchange of goods or services, which has to be paid for, its price reflects the costs of production, transportation and so on and most of these costs can be easily quantified. But a transaction is more than just a simple exchange it involves human interaction the cost of which may be difficult to quantify. These non-quantifiable costs of an exchange are transaction costs and in Russia during the 1990s they included:- the cost in time and money of dealing with surprise inspections and the arbitrary implementation of local regulations, of dealing with organised crime and protection rackets, in finding inputs, services and premises when information is scarce, trust levels low and property rights unprotected. These non-quantifiable transaction costs were high, and this was damaging because they can prevent opportunities from being exploited, but where enforcement is poor they encourage what North terms 'pirate' behaviour, and poor ethical business practices. Extensive networks helped to protect the former state-owned large enterprises from many of the negative effects of high transaction costs. Small firms on the other hand did not often have such extensive networks and were forced to rely more on the market, which left them vulnerable to opportunism and rent seeking and consequently more exposed to the negative effects of transaction costs.

Another important feature of this study is that it avoided producing an ethnocentric examination of small firm formation within a transitional economy. In other words it did not start out from the premise that the reactions of SMEs in Russia were 'irrational' because they appeared different from western-based models of entrepreneurial new firms. On the contrary from the beginning the actions of managers were considered 'rational' within their given context of operation. Consequently this study placed a greater emphasis on providing a deeper understanding of the context to explain the rationale for this behaviour. This meant



looking beyond the narrow economic environment to incorporate political and socio-cultural influences.

One incidental contribution this study has made is to the question 'who is an entrepreneur?' This study has shown that rather than concentrating on the 'person' it would be better to understand the 'entrepreneurial environment'. The entrepreneurial environment in nations differs because of the subtle differences in the informal and formal institutions that exist (historically and spatially). This study endorses the idea that there are unlikely to be common personality traits that are intrinsic to all entrepreneurs in all settings at every moment in history. This means that a small business owner in Latin America differs from a small business owner in post-Soviet Russia, or China, or the United Kingdom. As the structure (or context) of all economies differs then the demand for entrepreneurship will differ too (so a different type of entrepreneur may suit different contexts), this though increases the number of variables that need to be considered. In transitional Russia for example, the demand for entrepreneurship existed, but the entrepreneurial environment largely encouraged a wealth extractive form of entrepreneurial behaviour (and this may suit one type of personality more than another). Understanding the way small businesses establish and what they do in response to the 'entrepreneurial environment' or context can be more fruitful (than searching for common personality traits). Moreover, this approach to entrepreneurship recognises the differences that exist between small firms in different countries and while it offers all countries the chance to learn from the experiences of others, it suggests that policy responses designed to encourage entrepreneurship must be geared to local conditions.



## 7.3 The Development of the Conceptual Framework

The development of the conceptual framework was an important task. From the start it integrated an appreciation of the past with the influence of the socio-cultural and political environments as well as economic explanations. Arguably, this provides for a more complete understanding of an economic activity by grounding it into its broader contexts. Only through an holistic or integrated approach is it possible to analyse fully the factors and circumstances that make economies different. For example to explain the variances in small firm formation rates from one nation to another, between regions within nations, and from one period of history to another. One body of literature that appreciated both the influence of history and the role of socio-cultural and political environments is institutional economics, and it gave the conceptual framework its basic structure.

Although the key questions that guided this study were covered by the institutional economics literature, other approaches provided additional insights that developed the arguments. One useful literature discussed the role of small firms in regional economic development. In this literature the experiences of continental Europe (for example Third Italy) showed how small firm formation and activity could be theorised as a regional issue. This was important, for statistics in Russia depicted the regional differences that were appearing in the 1990s with regard to SME activity. Consequently examining the influence of economic space historically on small firm activity had the potential to offer important insights into the process of SME entrepreneurship.

A small firm study though should not exclude from its framework concepts used to examine entrepreneurship, which is a traditional focus of explanatory theorising in the SME literature. One potential difficulty was that concepts in this



material are usually operationalised to examine entrepreneurship at the micro rather than the meso level, which is the focus of this research. This difficulty with finding appropriate concepts to operationalise was eased by the diversity of research material on entrepreneurship available from different academic disciplines. In particular many important concepts came originally from sociology and examined not just social groups but cultural influences and how they interacted with economic incentives.

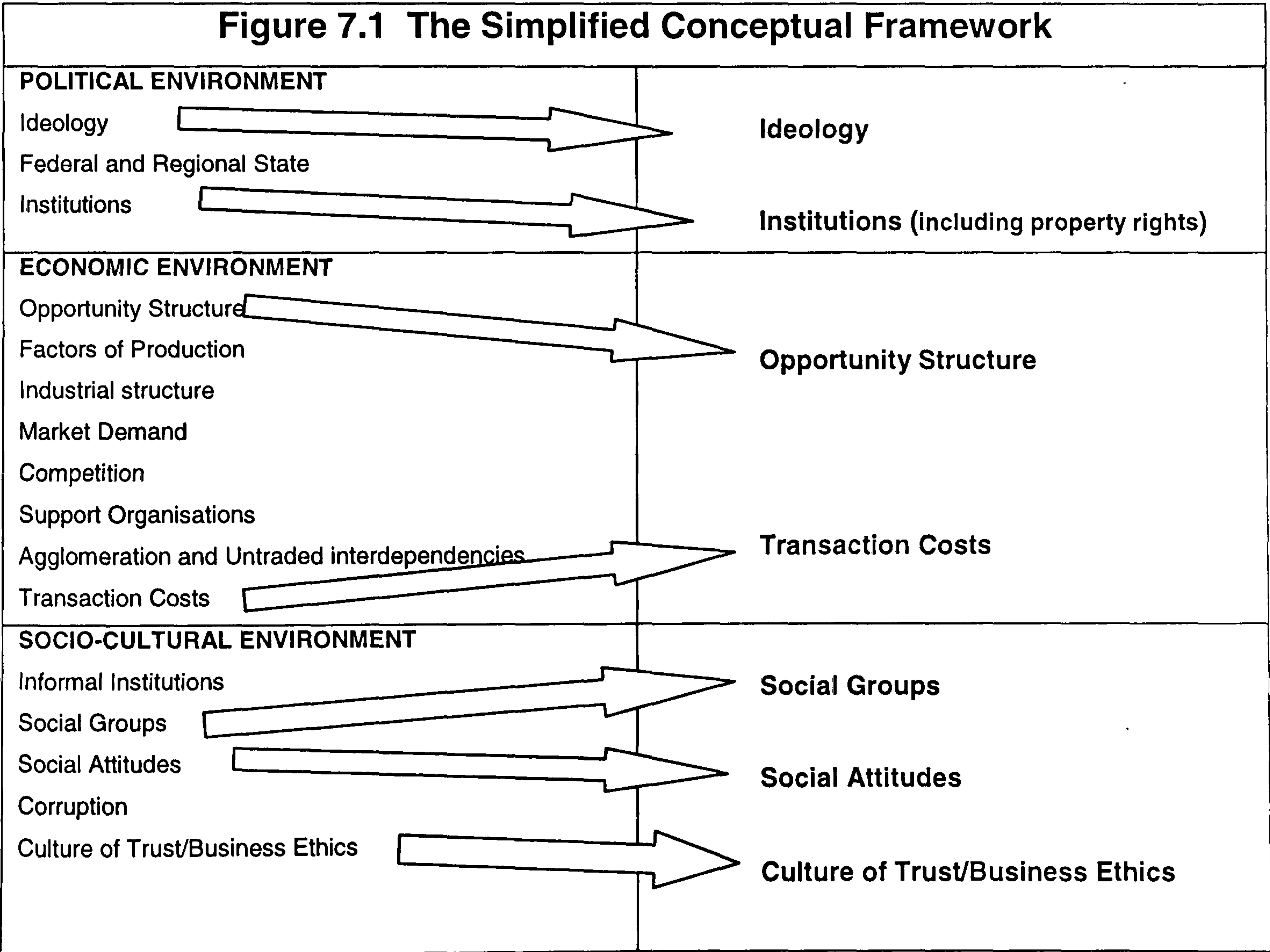
A critical evaluation of complementary literatures in chapter two yielded a set of potential explanatory concepts for understanding new firm formation. The conceptual framework went further by editing this list to eliminate repetition and inappropriate concepts for a meso level enquiry (see chapter three). This was a crucial step that helped organise the concepts into the three broad environmental categories or *milieux*, which together comprised the context within which SME activity occurs and must be understood. The environments were described as political, economic and socio-cultural, which is both consistent with the original literatures and maintains continuity with existing conventions of social science. It also conveniently characterises and helps locate each group of concepts. Locating individual concepts to a particular environment was usually straightforward, though at times it also involved a subjective judgement; the result was the conceptual framework see figures 3.1 (Categorisation of the Concepts) and 3.2 (Conceptual Framework) in chapter three.

This framework was subsequently used to order the narratives of the substantive chapters four, five and six and proved to be successful in providing coherent accounts of three contrasting periods. It was also able to identify similarities and differences in concepts determining the nature and extent of SME activity in each period, and in particular in highlighting the role of what could be called



the key concepts in the ‘entrepreneurial environment from all the periods taken together.

In fact the application of the framework in the substantive chapters stressed the importance of some concepts over others on SME activity see figure 7.1 (The Simplified Conceptual Framework). From the political environment the two key concepts to emerge were those of ideology and formal institutions (including property rights). From the economic environment the concepts of opportunity (or the market led demand for small firm formation) and transaction costs were particularly important, and from the socio-cultural environment, social groups (as sources of entrepreneurship) and their attitudes to small firms, as well as trust (including business ethics) emerged as particularly significant.





The next section will examine the key issues from each environment using an historical perspective to demonstrate how a deeper understanding of evolution over time (or path dependency) can aid our understanding of SME activity in the 1990s. In addition this section will relate these findings to a wider relevant literature, that has used similar concepts to analyse different yet related situations and what implications these approaches could have for Russia in the future.

## **7.4 The Central Factors for Understanding Small Firm Formation in Russia**

Small firm activity in Russia during the 1990s proved to be less significant than expected by many commentators. More important it meant that SMEs were not fulfilling all the roles they do in western developed economies (see table 1.1 in chapter one). The implication for Russia is that the process of creating a market economy is both long and complicated, but also the way the process is unfolding in Russia suggests that the market economy will look dissimilar and operate differently to other capitalist economies.

The substantive chapters have provided answers to the questions raised by this study and these will be examined here in sections that correspond to the order they were dealt with in the substantive chapters. This does not suggest any explanatory priority or importance, rather it is a pragmatic decision that has been fully rationalised elsewhere. To reiterate briefly, the two concepts that were considered most important in the political environment are discussed first, followed by concepts from the economic environment then concepts from the socio-cultural environment.



## 7.4.1 The Political Environment: Ideology, Formal Institutions and Path Dependence

This section analyses from an historical perspective how state ideology and formal institutions have influenced small firm formation throughout each of the three historical periods. Historically in Russia, ideology did not associate small firms with modernisation, and the formal institutions that were created reinforced this belief. Post-Soviet Russian ideology has changed and now emphasises the role that SMEs can play in a modern market economy. This ideology was reflected in the rhetoric of the state, but as chapter six has shown this was not always translated into an effective and adequate small firm policy with supporting organisations. The implication from this was that state ideology had not fundamentally altered, so although state rhetoric had changed substantially, state actions or behaviour lagged behind adapting slowly to the new market circumstances. This dichotomy between state ideology and behaviour was reflected in the formal institutions the state had developed.

### 7.4.1.1 Ideology and Path Dependence

Ideology is a belief system, a way of thinking and understanding, in other words it is an informal institution that guides the aims of the state in designing and implementing its formal institutions (policies, laws and so on). Chapter two showed in its discussion that belief systems evolve gradually over time, through learning and experience. The states of western developed market economies have had centuries to develop their ideologies to suit the kinds of economies they have developed into. In Russia though state ideology in the 1990s was expected to change over night as Russia created a market economy and its associated basic institutions. The old habits and ways of thinking about how an economy and business should operate



were proving difficult to dispel in the 1990s, and as this study has shown, were a continuing influence on both bureaucrats and the Russian public. Moreover, the old ideology that facilitated bureaucrats retaining their power would not change if they perceived that they would be the ultimate losers. Formal institutional change is driven by governing elites, but if these elites remain ideologically conservative (through self interest) then in real terms formal institutional change will be superficial and have a minimal impact. In other words, the way state ideology is evolving will be reflected not only in the formal institutions that are introduced, but also in the way these institutions operate. Inertia in institutional change may explain why some institutions in Russia in the 1990s were incomplete (for example full property rights)<sup>1</sup>, idealised (for example privatisation)<sup>2</sup> or perceived by others as a form of state racket (SME registration, certification and taxation).

Since the Tsarist period Russian state ideology has associated a modern wealth creating economy with large firms and the strong guiding hand of the state. Both of these fundamental belief systems have been slow to change in the post-Soviet period. So although privatisation and liberalisation reduced state interference at the micro level and its rhetoric changed to acknowledge the important role of SMEs (Solymossy, 2002), the institutions it created continued to favour the former state sector and state control. For example the belated introduction of small firm policy and programmes three years after the start of transition in 1995 was symptomatic of the lack of real change to ideology. In addition the state has been unable to resist shaping industrial development, and this helps to explain the findings expressed in SME surveys about the continued institutional barriers to SME activity in some sectors (Easter et al, 1998).

This slow move by the state to develop a specific small firm policy, legislation and dedicated support organisations (in other words to develop an 'institutionally



thick' environment) is not necessarily evidence of a lack of commitment, rather it is a reflection of the newness of this approach to Russian economic development. More to the point, it shows a need for the state to learn through experience about how a market economy works. The state by the end of the 1990s was to some extent responding to many concerns about the effects of institutions on SMEs by modifying those that were the most pernicious such as registration, certification, inspections and taxation. Although in the new century these barriers have been reduced, they still to some extent exist and continue to act as impediments to SME activity. Even more worrying was the continued wide-scale perception that despite change they nonetheless remained a form of state racket (and not a legitimate form of business and consumer protection). Such negative assessments of institutions could reduce further the prevailing low levels of trust and confidence in state institutions to protect business and alienate even more both existing and potential entrepreneurs.

An ideology that promotes the creation of 'good' institutions to protect and support all business, including SMEs is likely to take time to develop. The development of 'good' institutions will only happen when the power of the state is limited. This, according to North (1991a,b) and Acemoglu (2001, 2003) happens when those bureaucrats in charge take a more altruistic view, or believe that instead of losing they will benefit as much, if not more. As North has shown development of such an ideology need not ultimately happen, even when the benefits are recognised to outweigh the downsides. In the mean time the state is likely to retain an ideology that supports and protects the status quo. This was evident in Russia during the 1990s as formal institutions had not changed significantly to provide the right opportunity structure or the right incentive systems for SME activity.



#### 7.4.1.2 Formal Institutions and Path Dependence

State ideology then plays an important role in the design of formal institutions that shape the incentive and opportunity structures for SME activity. In post-Soviet Russia new formal institutions have been designed to encourage a modern wealth creating market economy, in which the state should play a less commanding role. In the early 1990s these new formal institutions were introduced and mixed with those inherited from the old Soviet system. Together these formal institutions created the nascent market economy and legitimised the right of small firms to form and grow in the formal economy. All formal institutions, no matter whether they are new, inherited or adopted from elsewhere, are a mix of incentives and disincentives and this was the case in post-Soviet Russia. So although the institutions created a demand for SMEs by changing the opportunity structure, they were also constraining and ironically pushed (or created the incentive for) small firms to operate either wholly or partially in the informal (rather than in the formal) economy.

The most important institution that needs to be created, in any market economy for transactions or economic exchange to take place on a large-scale, is secure and effectively enforced property rights. Full property rights have historically never existed in Russia. During the Tsarist and Soviet periods full property rights only belonged to the Tsar or the state, individuals only ever had partial property rights. Consequently the state historically has had the right to confiscate property, even to the point of moving people around the country. In the 1990s some aspects of state control over property rights were more difficult to overcome than others. For example although full property rights (use, sell, modify, destroy, bequeath, rent, transform and so on) existed in theory and in the constitution, they were not fully protected by law from the actions of others, including the state. This made small firm owners insecure over the control they had over the property, land, premises,



machinery, brands or profits and has shaped their investment decisions (Informant 7). Lack of protection for property rights in Russia then would have contributed to the low levels of SME activity (including start-ups and long-term investment) in the 1990s.

One of the most contentious issues in Russia throughout the 1990s was land privatisation. Land (both urban and agricultural) was not privatised at all during the 1990s, so all food-processing firms leased the land and premises they used. This had two consequences. Firstly there was the danger that local officials would not always recognise the lease, whether or not it was undertaken formally or informally with the former state-owned enterprise or local authority. Secondly because this type of property right was leased and as leases were prone to be rescinded suddenly, there was limited incentive for the small firm to make long-term investments. When property rights are this insecure not only is investment discouraged but opportunistic practices are encouraged (North, 1991; Acemoglu, 2001, 2003). North contends that the greater incentive will be to invest in the knowledge and skills that will make people better 'pirates'. This does not mean there will be an increase in outright criminal behaviour, rather the incentive is to engage in such corrupt practices as using official connections to be awarded state contracts. In other words poorly defined and enforced property rights are 'bad' institutions because of the kinds of incentives they encourage. The danger is that these 'bad' formal institutions can be difficult to transform into 'good' formal institutions because people would have learnt how to operate effectively with them (this may account for why the simplified tax was not liked by SME owners – see chapter 6, section 6.3.4.1 Taxation of Small Business).

Insecure property rights in the 1990s in Russia contributed to low levels of investment in business, consumption of profits and restricted transactions because of



the danger of opportunism (Easter et al, 1998). Consequently Scase's comments that small business in Russia was principally 'proprietary' rather than 'entrepreneurial', because the principal aim behind business start-ups was for consumption and not investment and growth (Scase, 1997) becomes more understandable. One though could argue that Scase's comments were overly critical, for they did not take into account that prevailing formal institutions discouraged potential and existing SME owners from being 'entrepreneurial' in his use of the term. One could conclude that 'entrepreneurs' were acting rationally in the institutional context they were in and were not being perverse.

The right kind of formal institutions that support property rights is stressed in the literature as a necessary prerequisite for establishing a wealth creating economy. Although in Russia in the 1990s the constitution acknowledged the existence of property rights, they were not properly enforced and contributed to discouraging SME activity. The importance of the right kind of institutions and property rights is examined in many different literatures. For example Acemoglu (2003) has examined institutions that were created in the past in former colonial nations and their influence over the centuries on their economic development. Briefly he found that those former colonial countries where full property rights were enforced by law to benefit broad segments of society became and remained wealthier than those where the institutions favoured wealth extraction by the powerful. He concludes that countries achieve wealth by having institutions that protect property rights and impose some kind of legal control over the government and elites. He also provides some hope for those countries with so called 'bad' institutions, by showing that Botswana was able to transform its highly dysfunctional institutions to create a well functioning democracy, though he did not indicate how this affected its economic growth.



Replacing existing 'bad' institutions with 'good' institutions that encourage business investment creates both winners and losers. The losers may include those in power that have used their positions for institutionalised rent taking (Olson, 2000) and to protect this advantage they may resist implementing change. This explains why institutional conservatism can remain and why there often needs to be a change in the composition of power elites for substantive institutional change to occur. The prime lesson from the literature is that good institutions are only created and enforced when one or other of two conditions exists (North, 1991). Either those in power perceive that they would benefit more through some form of compensation (for example their hold on power would be supported), or new groups favouring change manage to become powerful enough to impose it on the potential losers. In the 1990s in Russia there was no sign that either one of these conditions was beginning to take precedence. Unfortunately Russian politics was highly personalised with a multitude of different political groups but none were powerful enough to impose the kinds of changes needed (Christensen, 2000). Consequently in Russia the replacement of existing flawed formal institutions with 'good' or well functioning ones that would encourage economic development and SME activity had not occurred and may never occur. This may be an overly negative assessment as it ignores the important influence of isomorphism on institutional change that comes from being a member of the globalised world economy (DiMaggio et al, 1983).

If, however, it is difficult to change institutions at the national level, then the literature on Asia does show that change can be both easier to achieve at the local level and be more effective. The national level remains important for providing the basic institutional framework, but specific local problems that reduce development can only be adequately addressed at the regional level (Bardhan, 2000). For example Bardhan has shown how corruption was reduced when inhabitants were able to demand accountability from their local bureaucrats. It is not just the literature



on India that may provide suggestions to regional authorities in Russia about how to introduce 'good' well functioning regionally specific institutions. For example Leonardi (1995) stresses the importance of accountable regional government capable of designing specific institutions to prevent criminal activity and bureaucratic corruption. He has shown how local policies or programmes, that incorporated a series of checks, were developed, implemented and used as intended in some regions of southern Italy. These programmes resulted in business becoming empowered as a result of not having to worry about bureaucratic corruption and hence more able to exploit opportunities.

Webster (2003) produced an interesting theoretical paper that applied institutional analysis to the functioning of neighbourhoods. This research showed the importance of designing good institutions that are locally specific when he examined how property rights often determine the way economic space is used in urban areas. He demonstrated that even with full property rights tensions might arise in neighbourhoods when social norms change, or when individuals attempt to exploit common or public property to the detriment of others. The exploitation of public property by one party happens because the law over collectively used goods is difficult to define and difficult to enforce. Consequently it is not always possible to legally protect collective owners or other users from the actions of those misusing economic space. In other words the law may not (in all cases) adequately restrict a persons economic right to be a nuisance to others. Webster shows that the most effective way to protect all property rights is to have sophisticated and fairly enforced planning laws (institutions) with a high degree of local accountability. Again the literature stresses the point that local administrations can be more effective in developing specific formal institutions to deal with local issues, a lesson that Rostov oblast could use to its advantage when designing SME policy.



This study showed how difficult it was for Rostov oblast in the 1990s to design appropriate institutions and organisations at the local level, when the local administration had no previous experience to draw on. Historically institutions were designed centrally; the regional administration simply managed their implementation. The Rostov oblast administration consequently lacked the confidence to be creative when designing local formal institutions such as small business policy; instead it copied the national SME programmes. Accordingly it was not surprising to find that when the federal state re-directed its budgetary resources from SME programmes or failed to implement programmes that the Rostov administration did the same. In Rostov oblast this accounts for the reason why financial support was limited, why the premises of SME incubators were still in a state of disrepair and were not in service in 1998 and why the simplified taxation system had still not been introduced in 1998, three years after it was first mooted.

The literature shows that Russia was not alone in experiencing difficulties with creating market institutions and that it is just as possible to design 'bad' as it is to design 'good' institutions. In Russia it will take time, not least because the powerful elites belief systems need first to converge with official state ideology. More importantly for Rostov, the literature on the Third World and the West shows that change may best be achieved when locally specific institutions are designed to create economically productive regional economies that also overcome opportunistic behaviour by bureaucrats and criminal organisations.

#### 7.4.2 The Economic Environment: Opportunities, Transaction Costs and Path Dependence

The change to formal institutions during 1992 not only shaped the opportunity structure that created a demand for small firm entrepreneurship, but it also restricted



SME activity because transaction costs were not reduced sufficiently. The Russian economy in the 1990s was characterised by falling output levels, high levels of inflation, and falling levels of consumption, which suggested that the opportunity structure for SMEs was limited. Although this was true many opportunities did exist and were increasingly being exploited by SMEs in most regions including Rostov oblast, and one of the most popular manufacturing sectors for SME activity was food-processing.

#### 7.4.2.1 Opportunities and Demand in the Economy for Small Firms

Formal institutions shape the opportunity structure and the incentive system, which determines not just the opportunities or demand for SMEs but also whether these opportunities are taken up. Other factors in the economic environment such as the role of geography, consumer demand and access to factors of production also play a role in determining whether there are sufficient opportunities or demand for entrepreneurship.

Although Acemoglu (2003) shows that formal institutions are the primary influence on opportunities, he does acknowledge that geography can influence factor markets. Historically both geography and institutions in Russia have shaped demand in the economy for industry. In the Tsarist period it was the combination of emancipation, expansion of the empire and development of rail that opened up opportunities for food processing by creating a growing demand in urban areas and making it easier to exploit. In the Soviet period the state manipulated geography and the way that economic space was used by scientifically deciding where to disperse its large state-owned food-processing enterprises (either close to sources of raw materials or in cities). The effects of this Soviet location theory and the linkages



between state sector enterprises were still influential in the post-Soviet era of the 1990s and worked to limit demand for new small food-processing firms to act as subcontractors in the market. In addition the large former state enterprises have continued to dominate demand in factor markets through their networks of contacts, which have crowded out small firms. Consequently it became more difficult for small firms to enter markets where the prevailing relationships were already monopolistic and monopsonistic. Rostov oblast though was different to other regions in that it has a comparative advantage in agriculture. It was one region where there was a relatively large number of private 'fermerski' farmers in the 1990s who potentially could have supplied, but were not large enough to and not yet inclined to (via forming co-operatives with other independent small farms) supply, new small food-processing firms. Moreover the old former state-owned enterprises in the food processing industry retreated from serving some markets and generally were unable to pay staff wages on time and at good rates. Consequently niche market opportunities emerged in the 1990s and there were no problems in finding and retaining suitably qualified technical personnel in the 1990s (Informants 7 and 5). The informants interviewed also had no problems in finding suitable premises with all the utilities because of the large numbers of premises vacated by large firms. In Rostov then, the institutional framework and the restructuring of the former state-owned sector seemed to create some opportunities for small firms.

One important influence on demand in the economy for small firm formation in the food processing industry is related to the opportunities provided by the consumer market. As chapter five has shown consumption of processed food products did decline in the 1990s, and there was increased use of homemade products from the produce of household plots. The fall in consumption of processed food products was caused by two factors; the rise in prices following liberalisation and the fall in output by the former state-owned enterprises. The structure of consumption was also



affected by the polarisation of income (into the very poor and rich). In Rostov oblast for instance the polarisation of income caused an increase in consumption of cheap basic food products like bread as well as an increase in the demand for luxury items such as cream and meat products. Moreover small firms were best placed to supply these emerging market opportunities (that had not been taken by imports) after large former state firms had withdrawn from the market. The demand on SMEs to supply the market with domestically produced goods accelerated in the final quarter of 1998 in Rostov oblast, as a result of devaluation of the rouble in the summer. Unfortunately although this caused a temporary upsurge in demand that enabled SMEs to overcome some difficulties like high transaction costs, it was not a true sign of a broadly based growing market for manufactured food products in Russia's urban markets.

#### 7.4.2.2 Transaction Costs and Path Dependence

This study has indicated that there was demand in the economy for small firms to supply gaps in the market left by large firms and not covered by imports. In Rostov oblast, as elsewhere in Russia, whether opportunities were pursued and taken up by small firms, was determined largely by transaction costs. Transaction costs include elements that are both social and economic, with the economic costs being generally more easy to quantify, than the social costs (for example the quality of the business relationship and factors such as trust). Transaction costs are incurred because there is never perfect information, a contract is never 100% secure and there is always the possibility of one partner, who has more power (through the information (s)he has), of taking advantage of the situation for rent seeking purposes. In Russia historically there has never been full property rights enforced by law, and this was one reason why transaction costs for independent economic activity had always been high. This caused merchants in Tsarist Russia to be conservative in business, which limited



their operations and in Soviet Russia it was why the informal economy though significant was smaller than it was in the 1990s. In post-Soviet Russia high transaction costs were a disincentive to long-term investments, so the opportunities SMEs were encouraged to exploit tended to require short-term investments like trade and intermediation, and some manufacturing like baking.

The state did little in Russia during the 1990s to eliminate some of the most burdensome constraints imposed on SMEs by formal institutions and the actions of local officials, which meant that transaction costs were not reduced sufficiently. High transaction costs make the business environment and opportunities appear risky and unprotected, which can deter SME activity. In addition if transaction costs are high because property rights and enforcement are weak then SMEs will use personalised informal networks more extensively than they would in an economy where arms length transactions are protected by legally acknowledged contracts. Certainly the small firms interviewed during the course of this study made extensive use of personalised networks to find material inputs services, premises, equipment and labour (Informant, 5 and 7). Personalised exchange is a form of insurance against opportunism, but in post-Soviet Russia its more serious effect has been to limit SME business activity.

In Rostov, and more generally in Russia in the 1990s, market opportunities (or demand) did exist for domestic SMEs according to consumption patterns and import levels. Unfortunately the low level of SME formation rates indicated that many opportunities were not taken up. High transaction costs as a result of inadequate formal institutions were a major factor. Other reasons that prevented SME activity from increasing significantly in the 1990s can be found in the socio-cultural environment.



### 7.4.3 The Socio-Cultural Environment: Social Groups and Their Attitudes; Trust, Business Ethics and Path Dependence

The socio-cultural environment was examined in this study not just to understand the factors affecting the supply of entrepreneurs, but to appreciate the influence of informal institutions on the nature and extent of SME activity. In the West the social group most closely associated with entrepreneurship is usually the middle-class, in Russia there has never been a middle class, and social attitudes to non-state economic activity have tended to be negative. Consequently on the eve of transition in Russia the socio-cultural environment did not look as though it would be supportive of SME activity, and as informal institutions change slowly one would expect to find that by the end of the 1990s little would have changed.

#### 7.4.3.1 Social Groups, Social Attitudes and Path Dependence

Historically in Russia, social groups were engineered by the state and used as a form of social control for instance in the Tsarist period each social group had their own prescribed duties and obligations. The groups that had the opportunity to be entrepreneurial in the Tsarist period were those that had some power. Unfortunately weak formal institutions combined with informal institutions to encourage these social groups to engage in wealth extraction and consumption activities. Moreover the social group that most closely resembled what could be termed a middle class (the merchants), enjoyed little financial security, were concerned about social status and power, but also lived in a system without a state social safety net, and were as a result largely risk averse and conservative. In the Soviet period although social groups were still created by the state they were not officially allowed to set up their own small businesses or engage in entrepreneurial activities in the formal economy (until 1985 when co-operatives were allowed to form). There was an informal



economy, but the entrepreneurs here would have been those who were capable of using their connections with managers, officials or criminals.

In the post-Soviet period there was no obvious single social group to emerge from the process of social restructuring that was able to act as a source of supply for entrepreneurs setting up small firms. A middle class was forming and was investing in SMEs but generally this class was too small, and its potential members either too poor or consumption oriented to become involved with SMEs. How the middle class develops in the future will depend on whether the state can improve its formal institutions, pay a suitable living wage to public servants like teachers, doctors and nurses, and whether it allows those that have a stake in the economy to have some input in the democratic political process.

At the same time and historically social attitudes towards business and entrepreneurship have been unfavourable. In Tsarist Russia, trade and manufacturing were not respected as suitable activities for higher social groups. In the Soviet period non-state entrepreneurship was ideologically opposed as a form of capitalist exploitation. Although this ideology was reflected in social attitudes this did not prevent the informal economy from growing. Lack of legal protection partly accounts for why such negative attitudes to non state business remained in the 1990s, but it was also due to the belief that in the harsh economic environment where many institutions were also constraining, success could only be achieved through corruption and criminality. Consequently these negative social attitudes remained a disincentive to potential entrepreneurs in Russia during the 1990s. The only way to improve social attitudes is to improve formal institutions to ensure that they offer sufficient protection for wealth creation rather than wealth extraction.



### 7.4.3.2 Trust, Business Ethics and Path Dependence

Social attitudes towards business in Russia during the 1990s could be linked to the level of trust in society. Historically Russia has always been a low trust country, not only was there low levels of generalised inter-personal trust, but formal institutions and bureaucrats were also distrusted. The state, in the Tsarist and Soviet past, even encouraged inter-personal distrust to maintain its control over society by preventing a civil society from establishing. As a result by the beginning of the 1990s, there was limited experience of trust based relationships outside close family and friends. The experience of forming trust-based relationships did not improve in Russia during the 1990s even though an embryonic civil society was emerging, because only a small percentage of the population was involved in it. In Russia it was a combination of distrust in formal institutions, the experience of corrupt officials and low inter-personal trust that contributed to restricting SME activity. This was because low trust prevented non-personalised transactions supported by a legally protected contract from being used extensively by business.

Leonardi (1995) identified in his work on Italy how important non-economic factors such as social norms and mutual trust were for helping regions adapt to change. He showed that trust helped to build up business to business networks that then supported flexible specialisation in the industrial districts in Tuscany. He suggested that the local state can support this process without becoming too involved, by devising special programmes that encourage collective action and the development of trust for a successful outcome. This study showed that law and enforcement though important need not always be vital for business growth, especially if inter-personal trust in society is high (see also Rose, 1998).



Low trust in Russia was not just caused by the lack of experience with a civil society it was also influenced by the presence of criminal organisations, and the level of corruption that was socially tolerated. Chapter five showed how for many the informal economy was the only experience of a market type economy during the Soviet period. The informal economy however, was widely connected with criminal organisations and the kinds of business ethics they operated under are not generally those that will encourage economically productive activities, but these were the ethics that were inherited into post-Soviet society. Turning around a system that almost condoned some types of criminality and corruption requires systematic and consistent enforcement of the rule of law, which would help to weaken criminal organisations activities and also reduce official corruption (Leonardi, 1995).

For formal institutions in Russia to become effective regulators of small firm activity and to produce disincentives to illegal activity, and to encourage operations in the formal economy, the state needs to encourage trust. Rose (1998) has shown that although past experience of the way formal institutions operated matters, it is recent experiences and perceptions that tend to be more influential on public opinion. Consequently it may be possible to improve trust in the state and in local officials for example by improving government performance in public service delivery and in the behaviour of politicians, public servants and the judiciary. More to the point he has shown that even when civil society is weak and inter-personal forms of trust low, there can still be improved levels of trust in political or formal institutions as long as the performance of the state has improved. Rose (1998) concluded that trust in the state and local officials can be nurtured through changes in governance, and that the state administration can earn trust through honest and effective performance of its public responsibilities, and this is now what Russia needs.



In brief, this study has answered the original research questions by showing how formal and informal institutions interact to shape the way small firms are forming in Russia and in Rostov oblast in the food-processing sector. In general, there was a market led demand for new small firms in the Russian economy as a result of transition in the 1990s. In Rostov oblast in particular a gap appeared in the market for the right priced products because the former state-owned sector had reduced output and low income levels contributed to the low consumption of imported processed food products. Moreover the polarisation of income shaped demand and created opportunities for the production of low cost products like bread and luxury items such as meat products. Although opportunities existed in the economy for new small firms they were not taken up in the formal economy, this was because the formal institutions were so constraining and transaction cost so high that they appeared to be pushing the SME sector into the informal economy. Moreover, inherited informal institutions (especially habits and routines) exerted a considerable influence on new formal institutions that they were unable to operate as they were designed to. The new formal institutions, often based on western models, failed to reflect the way business and the economy worked in Russia in the 1990s, and did not enjoy the unqualified support of powerful elites. In this sense they could be characterised as 'bad' formal institutions. 'Good' institutions that encourage wealth creating SME activity in the formal economy need to be created by the state and implemented with conviction. The literature suggests that this may be best achieved at the regional level. Unfortunately in Russia, as shown in the experience of Rostov, the regional state has not been creative in developing its small firm policy and improving its institutional matrix. As a result, SME activity was low in the 1990s and confined to those sectors where capital investment requirements were modest. For example as the experience of Rostov oblast showed, the food sub-sectors that attracted investment were those that needed the least capital investment such as baking, moreover they remained small, technically conservative and not very



adventurous because the institutional and harsh economic environments did not encourage long term investment.

## **7.5 An Assessment of the Conceptual Framework and Methodology Employed**

The framework that was employed in this project was broad, as a result of needing a comprehensive analysis of social, political and economic factors that incorporated an historical dimension. This was understood as the strength of the model for it acknowledged that economies differ as a result of the different political and societal development paths taken and that relevant factors may recombine at particular historical moments and in particular places. Only in an analysis combining the effect from the socio-cultural and political environments with the economic environment was it possible to reflect the interconnections between them and the reality that they have periodically produced in Russia. This meant that the framework had to be flexible enough to be applied to any nation, whether or not it had systematically followed a western economic development model, and also to recognise regional specificities. This was particularly important for this project, as Russia has developed in its own unique way, and is also a large, geographically varied nation. Another benefit of this model is that it allowed for flexibility in the research methods being applied.

The framework consequently pointed to the employment of a variety of research methods. This implied the need for a flexible approach to the collection of data from the field, supplemented with data from other secondary sources. Flexibility was essential for the fieldwork for a number of reasons. Firstly time in the field was limited. Secondly the timing of the research trip coincided with the devaluation of the rouble (Autumn 1998) which created an unsettled economic environment that made



arranging interviews difficult. Thirdly Russia is a challenging place at the best of times for the researcher, because even fairly simple research tasks are invariably met with difficulties. This research needed to put methods together that would not just provide evidence, but evidence that could be confirmed or verified. It is a strength of the conceptual framework employed that it was robust enough to allow this flexibility in methodology, in terms of the types of evidence collected and methods of data collection. In practice the methods that were deemed the most suitable for obtaining data both in the field and outside were interviews with key informants, statistics from official sources, plus secondary literature from a variety of sources. These included : - the internet (Russian and English), academic books (Russian and English), newspapers (Russian and English – local and national) and journal articles (Russian and English) and economic analyses prepared by local and international development agencies, especially on SMEs and the food sectors. Obtaining the data from such a variety of sources increased the depth and credibility of the research.

One important method used in this research was interviews with key informants. Unlike some other small business studies in Russia (Smallbone et al, 1995b, 1996c), where surveys or structured interviews with many informants were used, this study started out with the intention of using a small number of key informants. The benefit of this was that it would facilitate the identification of issues that may not have arisen with any other method, such as large-scale surveys. Another benefit with using key informants was that it was not dependent on identifying and interviewing a large number of subjects. This was important for the research field trip was of a short duration and had limited resources, moreover it had already been realised that many small companies in Russia were not listed in a telephone book or were not identifiable from the roadside. The disadvantage of this was that there was a danger that a small number of key informants would introduce



bias. Combining interviews with the literature was considered to be sufficient enough to reduce potential bias. Another practical benefit of not interviewing too many subjects was that there was limited time in the field to obtain and read the local secondary literature that has been so important for this study. The key informants were drawn from small business, foreign organisations specialising in helping small business, foreign technical organisations, departments in the regional authority, and local academics (see appendix 1).

The framework employed in this project was not reliant on one specific method over another, and as a result it was not so dependent on interview material. It became evident, that more interviews would have been advantageous for obtaining additional data on issues raised in the framework, especially from the informal institutional perspective, such as the extent of and interpretation of habitual actions and trust as well as the extent and impact of corruption. This kind of information though is best obtained over time from key informants, who themselves learn to trust the interviewer and who gradually divulge more information as they relax into the discussions. The short duration of the field research meant that extensive interviewing of the same informants over weeks was not possible, so information and themes obtained from informants needed to be used in conjunction with secondary written sources. Since the literature sources used were not originally designed to answer the research questions this meant that the interpretations drawn from it and the interview material might not be fully nuanced.

Interviews with key informants were important sources of information but this was always verified through the use of secondary data. The use of secondary data from a variety of sources such as academic books, journals, newspapers, research reports and unpublished academic research papers and from the internet, were important sources of data in their own right. Interviews were limited by the duration



of the field trip and the difficulties involved in arranging them. As a result the various literatures and electronic media became the main source. The principal issue here is that the information in these articles had been written in accordance with the original author's framework and the information was interpreted through that author's viewpoint. The result was that within the articles there was likely to be a predisposition to a certain theory, viewpoint, or policy bias. Such concerns were overcome by using articles written by a wide variety of academics and other organisations, as well as newspaper reports, and by being alert to bias and seeking to cross check opinions. Another weakness of using these sources is that they were written to fulfil different aims. This meant that specific information required for this study was sometimes either lacking or not in sufficient detail. Therefore, many different sources of secondary information were needed to piece together the data required that applied to the framework and to the specific research question under investigation.

At times there has not been sufficient information to cover all the issues contained in the conceptual framework. For example are corrupt officials unsympathetic to small firm formation? How does corruption really affect the conduct and strategic choices of new small firms? As a result, because corruption has been identified in many surveys as a problem it has as such been interpreted in this project as being problematic, to SMEs; however its real impact remains somewhat grey. Using key informants (for example Informant 7) and secondary data, although highly informative and for the most part rich in detail, does not give the same kind of desired information that interviews with more informants would have. As such, the conclusions that have been produced are valid, but they need to be rounded out by more research for example into the attitudes, experiences and behaviour of a broader range of key players. The credibility of the research though was not compromised, because it was aimed at a 'meso level' of explanation based on



research undertaken within Russia, in Rostov and on small business. Its strength is that it combines historical data and regional level data on Rostov, with insights from original field work, to create a structured systematic interpretation of the circumstances and factors influencing new firm formation in this region at a key moment in its development.

## 7.6 Further Areas of Research

This study was a successful first attempt to find data that would correspond with the conceptual framework. It showed that the framework was by and large successful in analysing why small firm formation has been slow during the 1990s in Russia. Transition in Russia and Rostov is still unfolding, in effect the 1990s were the early years of the transition process. In particular it would be interesting to see if the regional administration has since become more adventurous in designing its small business support policy, and with what effect.

It would also be beneficial to examine another geographical area with this framework in order both to contrast the experiences and to test the extent to which the framework can identify differences and similarities between regions in their small firm activity in the same sector. Another line of further research is to use the conceptual framework to analyse small firm activity but with the specific aim to create more appropriate policies that suit the three environments. This study has alluded to the role and influence of policies, and has also made the point that policies must be locally/sectorally specific. It has though stopped short of making policy recommendations, except to say that even 'good' institutional design is not adequate without a corresponding change in informal institutions and practices, unless



attention is paid to reduce transaction costs for SMEs, and unless active sources of entrepreneurship can be encouraged.

Another potentially valuable further research topic is to examine how successful small firm support would be if it were introduced at the community level (as opposed the regional level) in other words at village or neighbourhood level. It would be interesting to examine if and where this occurred, whether any of the impediments to small firm formation could be overcome because informal institutions and locally determined formal institutions create a more secure trust based environment, within which small firms have the confidence to establish.

Another potentially important research topic would be to examine the somewhat abstract concept of trust in more detail. This research study did not have enough time in the field to unravel the specific aspects of trust in Rostov oblast most directly relevant to SME formation and growth. Such a study (because trust is subjective) would require extensive indepth interviews to determine the differences in the nature of trust, both trust in institutions (the system and officials) as well as generalised inter-personal trust, and how this trust is affected by poor law enforcement and the presence of criminal organisations that prey on business.

Small firm formation in Russia was not seen as a national success story in the 1990s. Opportunities although limited for manufacturing firms such as those in food-processing did exist, but high transaction costs caused largely by poorly designed formal institutions and over burdensome regulations meant that they were largely undertaken in the informal as opposed to the formal economy. If both the informal and formal economies had declined as a result of transition then it would be possible to say that opportunities or market led demand for small firms was low. The fact that the informal economy grew indicates that this was not the case. Russia and Rostov



region have not yet created 'good' effective institutions to encourage SMEs to form in the formal economy. Creating 'good' institutions is not easy; in the West they evolved over centuries as a result of experience and by taking into account social norms and habits. Consequently the first ten years of the transition process have been part of a long learning experience, for politicians, state bureaucrats, foreign advisers and business people alike. A learning process that is far from concluded.

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### End Notes

<sup>1</sup> See chapter six (section 6.4.4, The Availability of the Factors of Production) property rights were shown to be incomplete, the ability to buy and sell all types of land only occurred in mid 2002. Newspaper reports show that there was little protection for property rights in law, the state could confiscate, and it was not uncommon for small firms to receive visits from local state officials who wanted to extract bribes (Ericson, 1997, The Irish Times, 27<sup>th</sup> June 2002, The Economist, 7<sup>th</sup> July 2001, The Moscow Times, 25<sup>th</sup> December 2003, 16<sup>th</sup> September 2004).

<sup>2</sup> Privatisation was thought by some to be necessary because once it had occurred, owners of firms and property would have the incentive to innovate, invest and operate. Privatisation in Russia during the 1990s had not led to such behaviour see chapter six for a brief overview (section 6.3.2, Economic Policy).



# Appendix 1

## List of Interviews and Contacts

Main Field Trip    September – December 1998		
Autumn 1998		
Moscow		
September 10 <sup>th</sup>		<p><b>Interview with A. Chepurenko an Academic Researching Small Business</b></p> <p>Institute: Russian Independent Institute of Social and Nationalities Problems</p> <p>Chepurenko provided information on SMEs in Russia and on the difficulties of the current economic crisis. He considered there would be fewer food-processing SMEs in Moscow region than in the provinces, except for poor quality mini bakeries. He also emphasised that informal finance is preferable to bank finance and that Russian entrepreneurs had trained in the previous system and therefore lacked suitable experience and qualifications for a market economy</p>
September 15 <sup>th</sup>	Informant 1	<p><b>Interview with a Representative from ACDI/VOCA an American Organisation</b></p> <p>This organisation provides SME support in several Russian regions (though not in Rostov); it arranges for American business people to provide technical advice. He mentioned that the Know How Fund had experienced difficulties operating in Rostov because of a general resistance to change in the administration. He provided general information on the difficulties that international organisations have in operating in the regions, as well as the high expectations Russian SME owners had for international support.</p>
September 16 <sup>th</sup>	Informant 2	<p><b>Interview with a Representative of Scottish Trade International in Moscow</b></p> <p>This organisation helps Scottish business (especially in the food industry) to invest in Russia, including in Rostov oblast. He talked generally about the food industry in Russia. He spoke about the origins of ‘Dovgan’ a Russian company, which promotes domestically processed food products. He also said it was difficult doing business in Rostov because Russians are particularly loyal to their own domestic food products. He talked about a delegation of Scottish businessmen arriving in October in Rostov, and provided a contact telephone number for the Rostov Chamber of Commerce.</p>



	Informant 3	<b>Interview with a Representative of USAID</b> This representative provided some literature (Easter et al, 1998) and details about its programmes in Rostov.	
<b>ROSTOV OBLAST</b>			
September 28 <sup>th</sup>	Informant 4	<b>Interview with a Representative of USAID</b> A brief meeting, where the representative agreed to help with introductions to some small firms. A very general discussion about SMEs in Rostov region, especially concentrating on taxation and Kalmykiya. If firms register in Kalmykiya, a sort of off-shore tax haven, this can cause problems with the authorities in the home region where the business is based. As a result few Rostov SMEs will register there.	
September 29 <sup>th</sup>		<b>Meeting with a Representative of the Chamber of Commerce</b> Of limited help but confirmed when the Scottish delegation would arrive in Rostov oblast. Provided contact information for the Britain-Russia Center in Rostov on Don.	
October 2 <sup>nd</sup>		<b>Meeting with a Representative of the Britain-Russia Centre</b> This organisation is part of the Know How Fund. Mainly concerned with helping employees in the coal industry to set up SMEs; none were in the food sector. Spoke about British interest in Rostov -the 'British Pub', and an English businessperson working in the agro-food industry. Unfortunately they were not interested in meeting.	
October 6 <sup>th</sup>	Informant 5	<b>Interview with a Small Business Owner – Wholesaler - Organised through USAID</b> A small business owner. This informant considered that the local authorities are of little help. This wholesaler was told by the authorities to develop a restaurant for local bureaucrats as an incentive for them to treat him well. Former state-owned enterprises only produce and package in bulk, this SME spotted a gap in the market to supply local small shops. He re-packages butter, beer and water into smaller quantities. Finding suppliers of goods and packaging was easy; he looked in local newspapers. It was more difficult to find constant suppliers of butter because of a shortage of milk. He has 3 quality certificates from the authorities. He has to contend with many visits from the police, sanitary inspectors and fire officers. He does not pay all taxes, therefore pays bribes to inspectors so they will not inform on him. He uses the local employment agency for workers, because he has a contact in this agency who helps him find specialists. He had plans to expand the business; this involved getting the technology to manufacture fruit juices using local raw materials with finance to come from USAID.	



October 8 <sup>th</sup>			<p><b>Meeting with a Representative at the US Investment Fund</b></p> <p>He would not be interviewed himself, but would help arrange meetings with SMEs. He arranged the meeting with a baker, Informant 7</p>
October 14 <sup>th</sup>	Informant 6		<p><b>Interview with a Representative from the Meat Union (Donmysaprom)</b></p> <p>He talked about the way the food industry was organised in the USSR and in the post-Soviet period. New small meat processors he considered were not hygienic nor do they produce high quality products. They exist because of corruption; in other words they pay bribes to sanitary inspectors. Moscow now uses imported meat because their imported new equipment needs carcasses that have more meat on them. Russian carcasses have less meat on them; this was why Rostov agricultural firms have lost their buyers in Moscow. He also provided information about how the union finds raw meat, which it distributes, but only to processing firms that are members of the union – in other words the union does not help SMEs.</p>
October 15 <sup>th</sup>	Informant 7		<p><b>Interview with a Small Business Owner – Baker - Organised Through US Investment Fund</b></p> <p>This baker found gaps in the market; he knew that the large bakery no longer produced enough. His previous commercial experience provided him with connections that gave him easy access to raw materials. He uses informal networks for information (about potential employees, equipment, sources of inputs, finding premises (the kindergarten, which he leases though he would like to buy) and so on). He used his own finance from trade to buy equipment from Turkey, which he said he bought because it appeared to be good quality, but having used it, he considers it is poor. Before the crisis in 1998 he used bank finance, but he can no longer afford it. He is a member of an informal bakery association, so when he had a technical problem he contacted another member, who helped him by producing his bread for the next day. He could not afford to lose his customers, and was concerned about letting them down. He does not advertise his products; instead he relies on recommendations from satisfied customers and contacts. There is also an on-site shop (a simple hatch in the wall facing the street). He produces 16 different types of products, including biscuits and macaroni. He is forced to pay bribes to officials for licenses (he has 5 licenses, all last one month) and quality certificates, which last a year. He does not pay all his taxes.</p>
October 16 <sup>th</sup>	Informant 8		<p><b>Interview with a Representative of the Conserve Union (Donkonservprom)</b></p> <p>This union helps its member, the large former state-owned conserve factories to survive and facilitates co-operation between them. He acknowledges that there are many SMEs in this industry, but it is mostly home</p>



		production so the exact numbers are unknown. Like the Donmysaprom representative, he has contacts with conserve unions in other regions. He compared conserves to gold, saying they could be used to pay for taxes and supplies. Factories use davalcheskoi cyre – a way of paying for supplies in an indirect and convoluted manner. For example a soda maker gives soda to the glass maker, who gives glass to the tin factory, which gives tins to the conserve factory, which sends products to all of these factories, as a form of payment.
October 20 <sup>th</sup>	Informant 6	<b>Interview with a Representative of the Meat Union (Donmysaprom)</b> This representative considered that the local administration does not help Russian business it only takes bribes. In the Soviet Union there were 38 meat plants, in the 1990s this fell to 17. Consumer demand has changed in response to falling income levels; therefore meat-processing companies in this union are now producing cheaper boiled meat products. No state orders now for meat companies in the union; the union tries to arrange finance for former state-owned meat-processing firms, but only if they have good business plans.
October 22 <sup>nd</sup>	Informant 9	<b>Interview with a Representative of the Department of Agriculture</b> He spoke about the old soviet food system. The unions had always existed in Rostov; they were an attempt to improve links between different elements in the food sector. A Russian gas company bought up farms in Rostov oblast in 1990s. Specialist farms in the USSR also produced a range of different products, because of the plan and geography. Milk industry still survives in Rostov oblast, but unlike Krasnodar there is no money to invest in the new forms of packaging. He talked about the market and how the mechanisms to enable it to work efficiently were not yet in place. All farms suffer because there are no subsidies, but in the West farmers still receive government subsidies. The new private farmers are not interested in agriculture instead they build nice big houses and buy cars. He blamed Tacis for breaking up agriculture, and condemns them for not reconstructing it.
	Informant 10	<b>Interview with Small Business Owner - Baker – Found Through Informant 7</b> He provided similar information to the first baker. He too was involved in trade before becoming a baker. He talked about the difficulties for finding finance as a result of the currency crisis.
October 29 <sup>th</sup>	Informant 11	<b>Interview with representative from USAID</b> This programme is called 'Opportunity' and they provide SMEs with easier access to finance than bank credit. They also provide other services, consultancy, legal help, accounting and seminars. They have operated for 3 years and have helped around 500 enterprises. Most of the firms they help are in trade because they need less



		financial support. He talked about the good reputation of some old former state-owned firms; the local authorities help them avoid bankruptcy but not by providing finance. He said that it was very difficult to get licenses. It is difficult to establish the number of taxes small firms were required to pay because they were constantly changing. Small firm owners need to employ accountants to read the daily newspapers to find out about tax changes. It is easy to find premises because many organisations are bankrupt and have space available. He said that in his opinion only strong firms diversify their operations, because the owner is pulled into too many directions. He considered that the crisis would provide opportunities for SMEs in Rostov.
October 23 <sup>rd</sup>		<b>Glasgow Delegation in Rostov Oblast</b> Attended their meeting together with farmers from Rostov oblast.
		<b>Interview with a Representative from USAID</b> They provide cheap finance and other business services to SMEs. Most small firms they help are in trade and services because they need less finance than those in manufacturing. Authorities help former state-owned bakeries because they have good reputation and will not let them fail because of social costs. Obtaining licenses is difficult, taxation system unclear.
November 12 <sup>th</sup>	Informant 12	<b>Interview with a Representative of the Regional Administration in Rostov Oblast</b> Department for the Support and Development of Small Entrepreneurship She provided information about the local administration's SME support programme. They have a four part support programme. They have two new centers the regional center for support of small business and a marketing center. State support is not a subsidy, it is a credit that has to be re-paid. Registration takes 3 days and it is not expensive, just need lots of documents; the whole process can take 2 weeks to one month. Administration in Rostov oblast only began helping SMEs in 1997 therefore still building the support infrastructure. Each town has an SME support centre that provides information on exhibitions. Dom malogo biznesa opened in January 1998 and provides a variety of free services.
November 16 <sup>th</sup>	Informant 13	<b>Interview with a Representative of the Fund for Small Business Support.</b> He provided contact with an academic working in area of SME research and literature about the region's SME programme. He said it was difficult to know precisely the kind of documents needed for registration and it was easy to miss something. He was unable to say how many firms this programme has helped. He said that the incubator was still not open in Rostov town centre.



November 23 <sup>rd</sup>		<b>Interview with a Representative of the EBRD</b> Provided anecdotal information on the food industry in Rostov oblast.
November 26 <sup>th</sup>		<b>Meeting with a Phd Student – T. Shipilova</b> A pamphlet summarising this student's Phd was found in the library. She allowed parts of thesis to be photocopied, and said that many statistics needed for my study would not exist.
<b>Exploratory Field Trip February – April 1998</b>		
Moscow		
February 27 <sup>th</sup>		<b>Meeting with a Representative of Tacis</b> He was of the opinion that all activity in the food industry still subsidised by the state, despite denials; there are many different ways of subsidising that are not immediately obvious. The mafiya has a strong role in the food industry in Russia and especially in Moscow.
		<b>Interview with A. Vilensky an Academic Researching Small Business</b> Institute: The Higher School of Economics He talked in general about the problems of SMEs, confirmed information from the literature. He said that only a few SMEs were in manufacturing most were in trade.
Nizhny Novgorod		
March 3 <sup>rd</sup>		<b>Meeting with Terekov an Academic at a Local Agricultural College and a Small Baker</b> This academic provides a consulting service for private business, including information about obtaining supplies, and how to produce good food products. This institute produces a variety of agricultural products, which it sells to students and staff, some of which is processed. He introduced me to a baker who acquired sufficient finance through trade to start up a small bakery. The baker was previously a physicist; who saw a gap in market and sells bread to hospitals and kindergartens, emphasising its unique healthy properties.
March 6 <sup>th</sup>		<b>Interview with a Representative of the Small Enterprise Equity Fund</b> This organisation buys up shares in SMEs to sell later. This representative was generally impressed by the quality of SMEs in Nizhny Novgorod. He remarked on the high taxes and considered the government was not doing enough to help SMEs, infact it was thwarting SME formation and development. In his opinion government departments duplicate their activities, which creates confusion. He then talked about some of the SMEs his organisation had worked with.



March 10 <sup>th</sup>		<p><b>Meeting with a Representative of EBRD</b></p> <p>This representative said that SMEs in food processing tend to be located on the outskirts of towns. He talked about what the EBRD is doing in Nizhny Novgorod, and the difficulties they have experienced. Unlike many people in the West this representative had a poor impression of Nemtsov, the former governor, and the reforms that have been undertaken in Nizhny. He then talked about taxation and how companies attempted to avoid it, as well as the inability of the legal system to protect business.</p>
March 11 <sup>th</sup>		<p><b>Meeting with a Representative of Price Waterhouse</b></p> <p>Provided information about doing business in Nizhny Novgorod.</p>
<b>Rostov Oblast</b>		
March 25 <sup>th</sup>		<p><b>Meeting with a representative of YugAgroFund</b></p> <p>This fund provided a booklet about farm restructuring in Russia, and engaged in a brief chat about the food industry and farming in Russia.</p>
March 26 <sup>th</sup>		<p><b>Meeting with a Representative of Tacis</b></p> <p>Provided help finding contacts and also information on their programmes.</p>
March 30 <sup>th</sup>		<p><b>Meeting with a Representative of the US Russia Investment Fund</b></p> <p>Spoke in general about the food industry in the oblast, indicated that he would help provide contacts with SMEs during the main research trip.</p>
March 31 <sup>st</sup>		<p><b>Meeting with a Representative of the EBRD</b></p> <p>This representative gave his personal impression of the food industry in Rostov oblast.</p>
April 1 <sup>st</sup>		<p><b>Meeting at Tacis – Met with a Representative of Opportunity</b></p> <p>Attended meeting with small baker, who was told to concentrate on bread and not logging. If he insisted on dealing in two products ‘Opportunity USAID’ would not be able to provide him with any finance.</p>



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